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Beyond the GAAP

Mazars' newsletter on accounting standards

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Edito

At the beginning of the second half of 2014, it appears that some preparers have initiated an action plan to analyze their contracts with customers in the light of IFRS 15. Starting early this project will enable to identify practical implementation difficulties that deserve to be referred to the Transition Resource Group, which held its first meeting on 18 July.

This July is also the publication date, for many European groups, of their first interim financial statements using the new consolidation standards. In this context, Mazars published a study on the application of these standards by European Corporates in their financial statements as at 31 December 2013. Details of this study are presented on the last page of this newsletter. We hope this will be useful to anticipate your 2014 year-end closing.

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

IFRS Highlights

IASB to create a transition resource group for IRFS 9

On 23 June 2014, the IASB announced its intention to create a transition resource group focusing on the new impairment model in IFRS 9, publication of which is expected this year.

This group, known as the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) will provide a discussion forum to support constituents on implementation issues that may arise as a result of the new requirements in IFRS 9, given the magnitude of the changes.

The IASB is seeking nominations to form a group to consist of 14-18 specialists representing financial statement preparers, auditors and other stakeholders.

For more information, visit the IASB site at: http://www.ifrs.org/Alerts/ProjectUpdate/Pages/IASB-to-establish-transition-resource-group-for-impairment-of-financial-instruments-June-2014.aspx

IASB issues amendments for bearer plants

On 30 June 2014 the IASB published amendments to IAS 41 *Agriculture* and IAS 16 *Property, Plant and Equipment*, relative to the financial reporting for bearer plants, such as grape vines, rubber trees and oil palms.

These amendments mean that bearer plants should be accounted for in the same way as property, plant and equipment according to IAS 16. Bearer plants will therefore be accounted for using either a cost model or a revaluation model rather than fair value less costs to sell as is currently the case in application of IAS 41.

These amendments will be of mandatory application to financial periods from 1 January 2016. They are expected to be endorsed by the European Union during Q1 2015.

Leases: further redeliberations

The IASB and the FASB have continued their deliberations on the draft standard on Leases, and have discussed the following topics:

- subleases;
- lessee balance sheet presentation;
- cash flow presentation.

The decisions reached during this meeting serve as a reminder that the two boards have been unable to reach a joint position on lessee accounting. Therefore, they have decided to retain their own existing models (for more details, see *Beyond the GAAP,* March 2014), so that the IFRS and US GAAP requirements for the presentation of leases on the balance sheet and in the cash flow statement will differ.

EUROPEAN Highlights

ESMA report on the quality of financial information on business combinations

On June 16 2014, ESMA published a report entitled *Review on the application of accounting requirements for business combinations in IFRS financial statements* in which it sets out the results of its review of the disclosures provided in 2012 financial statements by a sample of 56 issuers in the European Union, covering 66 business combinations.

ESMA appears generally satisfied with the quality of the information provided by issuers about business combinations, though it notes that improvements are necessary in some areas.

ESMA observes that:

- issuers tended to present information about the fair values of major assets and liabilities acquired at a level aggregation that is too high to be intelligible, or even to aggregate this information for items of a different nature;
- issuers often mentioned that the fair value of assets and liabilities had been determined by external valuations, but very seldom gave details of the valuation techniques used to do so;
- in nearly a quarter of the business combinations analysed entities did not recognise any separate intangibles from goodwill;
- bargain purchases were more frequent than might be expected, but a third of the issuers in which a bargain purchase gain had been recognised disclosed no explanation of why the transaction resulted in a gain.
- As a consequence of these findings, ESMA recommends issuers to provide disclosures tailored to the specific circumstances of transactions. ESMA believes issuers should further improve the quality of the information by :providing relevant information about the factors determining the amount of goodwill or reasons for bargain purchase;
- providing more granular disclosures on the assets and liabilities recognised;
- applying consistent assumptions at the initial recognition and subsequent measurement of assets and liabilities; and
- improving the information provided on the valuation techniques and assumptions used when measuring assets and liabilities at fair value.

The ESMA report can be consulted at: http://www.esma.europa.eu/system/files/2014-643_esma_report_on_the_ifrs_3.pdf

EFRAG and European standard setters launch additional public consultation on Leases

ON 30 June 2014, EFRAG and the standard setters in France (ANC), Germany (ASCG), Italy (OIC) and the United Kingdom (FRC) launched an additional public consultation on lessee accounting.

The objective of this consultation is twofold:

- to identify transactions that would qualify as leases under the current proposals but that constituents view as in-substance service transactions that should not be recognised by a lessee;
- to seek constituents' views and their preference of the two alternative approaches proposed by the IASB and FASB respectively.

Replies should be submitted not later than on Friday, 22 August 2014. For more details about the public consultation, visit the EFRAF site at: http://www.efrag.org/Front/n1-1343/EFRAG-and-the-National-Standard-Setters-ANC--ASCG--FRC-and-OIC-invite-companies-to-participate-in-an-additional-public-consultation-on-lessee-accounting.aspx

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A Closer Look

IASB and FASB issue converged standard on revenue recognition

At the end of May 2014, the IASB published IFRS 15 on revenue recognition. At the same time, the FASB published ASU 2014-09 (Topic 606). These two broadly identical standards represent the conclusion of the boards' work on a major joint project that has taken many years to complete.

1. The main outlines

IFRS 15 will replace IAS 18 *Revenue* and IAS 11 *Construction Contracts*, and all the associated interpretations: IFRIC 13, IFRIC 15, IFRIC 18 and SIC 31. This standard will be applicable to all types of contracts with customers and all business sectors.

IFRS 15 will therefore be applied to the recognition of revenue from the sale of goods and services arising from contracts with customers (including construction, engineering or consulting contracts). IFRS 15 also sets out the accounting treatment for royalties promised in exchange for a licence of intellectual property. However, IFRS 15 does not apply to leases (which remain within the scope of IAS 17), insurance contracts (IFRS 4) or financial instruments (IAS 39 / IFRS 9).

IFRS 15 clarifies the accounting treatment for complex transactions (including multiple goods and/or services). IFRS 15 is much more detailed than other existing IFRSs. The standard (including application guidance), examples and basis of conclusions come to more than 250 pages!

Disclosures on contracts with customers will be much more detailed than today.

Further, in an unprecedented move a Transition Resource Group has been set up by the IASB and the FASB. This Group will identify and address any difficulties of implementation that may be posed by IFRS 15 (and Topic 606) between now and its effective date. The group will meet twice in 2014 (in July and October). Its discussions will be public.
The list of TRG members is available on the IASB site at: http://www.ifrs.org/About-us/IASB/Advisory-bodies/Joint-Revenue-Transition-Resource-Group/Pages/Group-members.aspx

2. Core principle of IFRS 15

The core principle of IFRS 15 is that an entity recognises revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.

The transfer of goods and services is based on the concept of transfer of control to the customer. This may take place at a point in time (for example when a good is delivered) or over time (for example as a service is rendered or a good is transferred to the customer).

3. Effective date and transition

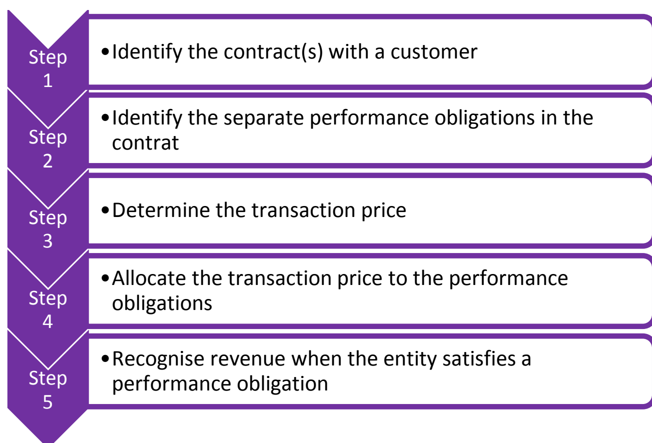
IFRS 15 will be of mandatory application for reporting periods beginning on or after 1 January 2017, subject to endorsement by the European Union. Early application is permitted. An entity has the choice:

- either to apply IFRS 15 retrospectively (with some practical expedients),
- or to apply an alternative method, only restating contracts current at 1 January 2017.
  In the latter case, the cumulative effect will be recognised as an adjustment to the opening balance of retained earnings (that is, at 1 January 2017) and it will not be necessary to restate the comparative periods presented. Consequently, contracts that are completed before 1 January 2017 (in compliance with existing standards, i.e. IAS 11 and IAS 18) will not need to be restated.

Entities are thus offered considerable latitude in their approach to the transition. An analysis of the impact of these two transitional methods will be required in the notes.

4. A five-step accounting model

In practice, IRFS 15 consists of five steps:



Readers should note that IFRS 15 applies in principle to each contract with a customer. However, it may be applied to a portfolio of contracts with similar characteristics if this gives similar results to those obtained by applying IFRS to each contract individually.

Step 1: Identify the contract(s) with a customer

This step may involve combining several contracts in order to account for them as a single contract. This is the case when the contracts have been concluded at the same or almost the same date and have been negotiated as a package with a single commercial objective.

IFRS 15 also clarifies the treatment of contract modifications (i.e. where the price has been renegotiated or the scope of the contract is changed).

If there is any uncertainty as to the collectability of the amounts due from the customer when the contract is concluded, no revenue is recognised as long as the seller has not delivered the goods or services and has not been paid (payments received should be non-refundable).

2. Identify the separate performance obligations in the contract

A performance obligation is a good or a service (or a bundle of goods and services) transferred to the customer that can be regarded as 'distinct' as defined in IFRS 15. In other words, a performance obligation is a distinct component of the contract.

For example, it is intuitively obvious that the sale of a motor vehicle accompanied by a maintenance contract on the vehicle (which goes further than a simple warranty as required by law) contains two distinct components: the sale of a good (the vehicle) and sale of a service (the maintenance). The same is true of packages sold by telecom operators which include the sale of a handset and the sale of a service (connectivity).

The identification of the performance obligations in the contract is crucial since the breakdown of the contract directly influences the date on which revenue is recognised (since different performance obligations may be fulfilled at different dates). For example, in the case described above, the vehicle is delivered / sold in June 2014 but the maintenance service will be delivered between June 2014 and June 2016.

It is much more difficult to identify performance obligations in the case of construction, engineering or even consulting contracts. In these cases, the seller provides a service of integrating the different goods or services sold to the customer. It is precisely this "integration service" that comprises the added value of the contract. In this instance, the level of integration of the goods and services transferred to the customer will determine whether several performance obligations or a single performance obligation should be identified.

IFRS 15 includes a list of indicators to help determine whether a good or service can be identified separately from the other goods and services provided in a contract.

Note that a sale contract for a series of distinct but similar goods (for example, the sale of a series of identical trains) may constitute a single performance obligation if each good would fulfil the criteria for recognition over time. In this case, recognition of the whole series of trains over time would not give a different result from that which would be obtained if each good were accounted for individually (as long as the method of determining the stage of completion remained the same; for example, on the basis of costs incurred to date).

Step 3: Determine the transaction price

The transaction price is the amount of consideration that the seller expects to receive (generally in cash) in exchange for the goods or services.

Entities must take account of variable consideration (such as bonuses, penalties, rebates, etc.). However, variable consideration will only be taken into account when it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Here the boards are clearly applying the prudence principle, although this principle is never explicitly mentioned in the standard.

The customer credit risk should not be reflected in the measurement of revenue, and any impairment of trade receivables or amounts due from customers (determined in accordance with IAS 39 / IFRS 9) will be presented separately in the notes.

The transaction price must also take account of the time value of money in the event of advance or deferred payments, insofar as this has a material impact on the amount of consideration that is received (i.e. the financing component included in the transaction must be recognised in financial income or expense). However, it is not mandatory to do so if the period between transfer of the good or service and the date of payment by the customer is less than 12 months.

Step 4: Allocate the transaction price to the separate performance obligations in the contract

An entity allocates the transaction price on the basis of the relative stand-alone selling price for each distinct good or service. If a stand-alone selling price of a good or service cannot be determined (in accordance with IFRS 15), the entity is required to estimate the stand-alone selling price using an appropriate method. The residual approach (the determination of the selling price of a performance obligation for which a stand-alone price cannot be determined as the difference between the overall transaction price and the observable stand-alone prices of the other performance obligations) can only be applied under strict conditions.

Stage 5: Recognise revenue when the entity satisfies a performance obligation

The revenue is recognised when the seller satisfies each performance obligation (i.e. at a point in time or over time as the work progresses).

The criteria for recognising revenue over time are stricter in IFRS 15 than in IAS 11 and IAS 18. The rendering of services will generally be recognised over time. Likewise, the sale of goods for which the transfer is "continuous" (cf. agreements for the construction of real estate in the scope of IFRIC 15) will be recognised over time. However, for construction, engineering or even consulting contracts, in order to be able to recognise revenue over time, the seller must have an enforceable right to payment for performance completed to date. This will be the case if the seller has a legal or contractual right to compensation for performance completed to date if the contract is terminated by the customer for reasons other than the seller's failure to perform the remaining works under the contract as promised.
The amount of compensation must correspond to a proportion of the transaction price, and thus include a reasonable margin.

The right to payment does not therefore need to be an unconditional right (i.e. a receivable). The boards noted that making the distinction between a contract asset (i.e. amounts due from customers) and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the rights in a contract. This is because although both would be subject to credit risk, a contract asset is also subject to other risks, for example, performance risk. In long-term contracts, a seller does not usually have an unconditional right to payment except at milestones well-established by the contract, or when goods or services are delivered in their entirety. The absence of an unconditional right to payment during the course of a contract does not therefore mean that revenue cannot be recognised as work progresses. The risk of non-performance by the seller of works that are to be performed in the future (and thus the likelihood that the seller may be obliged to return sums paid by the customer) does not affect the fact that the works performed to date have been transferred to the customer.

5. Does IFRS 15 provide additional guidance?

Areas in which IFRS 15 provides guidance include:

- sales with a right of return (revenue is initially limited to sales that an entity expects to complete);
- the distinction between warranties (covered by IAS 37 *Provisions*) and maintenance and service contracts (which are distinct performance obligations to which a "share" of revenue is allocated);
- options granted to customers to acquire additional goods or services at a discount (which are distinct performance obligations to which a "share" of revenue is allocated);
- sales with a repurchase agreement, which may be analysed as leases and accounted for under IAS 17 (for example in the case of a put option granted to a customer that provides the customer with a significant economic incentive to exercise his right to sell);
- licences (if they are distinct within the definition in IFRS 15), where an entity must distinguish between a right to access the intellectual property (granted to the customer continuously over the period of the licence) and the right to use the intellectual property (which is granted to the customer at a point in time). Royalties based on sales or usage are generally accounted for as revenue when the subsequent sale or usage occurs;
- consideration paid to the customer by the seller which systematically reduces the transaction price in the absence of identifiable goods or services delivered by the customer;

- non-refundable up-front payments made on conclusion of a contract (which cannot be accounted for immediately as revenue as they do not correspond to the delivery of a distinct good or service under IFRS 15);
- taking more systematic account of the financing component in a transaction (although there is a practical expedient, see Step 3 above);
- contract costs, which can only be activated if they are incremental (i.e. incurred solely in obtaining the contract) and recoverable. This would include commission paid to sales staff when a contract is obtained;
- costs to fulfil contracts with customers, which can be activated under certain conditions (if they are not activated under another IFRS, for example IAS 2 *Inventories*).

6. What are the expected impacts?

Entities will probably be impacted differently by IFRS 15, depending on the business sector in which they operate. At this stage it is too early to estimate with any accuracy the scale and nature of these impacts; as ever, the devil is in the details!

However, the telecom sector seems likely to be particularly affected. The current accounting treatment of bundled offers is out of step with the principle of breaking down a contract into performance obligations and allocating part of the transaction price to each of these performance obligations.

Entities that enter into long-term contracts (construction, engineering or even consulting) will have to look carefully the provisions of IFRS 15 regarding the date at which revenue is recognised. The criteria for recognising revenue over time are stricter in IFRS 15 than in IAS 11 and IAS 18.

In general terms, all contracts involving variable consideration (because of rights of return, rebates and discounts, penalties, bonuses, price adjustment clauses, etc.), may be affected by the provisions of IFRS 15.

Finally, all entities will be impacted by the increased volume of disclosures, even if this burden has been lightened somewhat by comparison with the proposals in the second exposure draft published in late 2011.

Against this background, all entities are urged to begin as of now to identify the impacts of IFRS 15, not least on their information systems.

A Closer Look

Endorsement of IFRIC 21 - *Levies*

The European Union has now endorsed IFRIC 21 - *Levies.* For entities that apply IFRSs as adopted by the European Union, IFRIC 21 is of mandatory application to financial years beginning on or after 17 June 2014.

For entities whose financial year coincides with the calendar year, IFRIC 21 must therefore be applied in 2015. Early application is permitted. IFRIC 21 must be applied retrospectively (like all changes in accounting principles).

The text can be accessed on the European Union web site at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0634&from=EN

1. Background

Readers will recall that this interpretation addresses the accounting treatment for liabilities relative to levies paid by an entity to a public authority in the financial statements of the entity paying these levies. The issue at stake is the date at which entities should recognise liabilities for levies other than income taxes (that are within the scope of IAS 12) or social security contributions (within the scope of IAS 19). IFRIC 21 therefore only addresses the accounting for levies which enter "by default" within the scope of IAS 37.

An entity may also opt to apply IFRIC 21 to the recognition of liabilities that arise from emissions trading schemes.

2. What does IFRIC 21 say?

IFRIC 21 clarifies that:

- the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation;
- the liability is recognised progressively if the obligating event occurs over a period of time;
- the recognition of the liability gives rise to an expense unless an asset is recognised under another IFRS (for example IAS 2 or IAS 38);
- the same recognition principles should be applied in the interim financial statements as in the annual financial statements; consequently, no liability may be recognised in the interim financial statements if the obligating event has not occurred at the end of the interim reporting period.

For example, if the levy is triggered by the generation of revenue in the current period (from the first euro) and the basis of the levy is the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is a necessary but not a sufficient condition to create a present obligation.

If the obligation to pay the levy arises progressively over a period of time, it is also recognised progressively over the period.

If a levy is only triggered when an annual threshold is reached (such as a minimum amount of annual revenue), the corresponding liability is recognised when that threshold is reached.
The fact that the annual threshold is reduced *prorata temporis* in the case of a discontinued activity does not affect this analysis (see the IFRS IC decision published in the March 2014 IFRIC). In our view, an entity should distinguish a levy due when a threshold is reached that is reduced pro rata when the activity is discontinued, from a levy the obligating event of which is progressive .

In most cases, it will not be possible to recognise an asset to offset the liability; it will therefore only be possible to spread the expense if the activity that triggers the payment of the levy arises progressively over time.

Illustrative examples

IFRIC 21 provides four illustrative examples:

- A levy is triggered progressively as the entity generates revenue during the period
- A levy is triggered in full as soon as the entity generates revenue
- A levy is triggered in full if the entity operates as a bank at a specified date
- A levy is triggered if the entity generates revenue above a minimum amount of revenue

For more details, see the study published in the June 2013 edition of Beyond the GAAP.

Events & FAQ

Publications

Mazars publishes a study on the application of the "consolidation package"

Mazars has just published a new study entitled "*The application of the new standards on consolidation (IFRS 10, IFRS 11 and IFRS 12) in Corporates' financial reporting as at 31 December 2013*"

This study has the following objectives:

- to assess the impact of the application of IFRS 10 and IFRS 11 on the financial statements: this analysis looks at both groups which opted for early application of the new consolidation standards at 31 December 2013, and groups which did not opt for early application, but which reported the expected impact of applying the new standards in the financial statements as at 31 December 2013; and
- to identify good practice in financial reporting among the groups which opted for early application:
  - as regards transition; and
  - as regards recurrent application of these standards (notably IFRS 12). The study is thus intended to be a guide to IFRS 12, highlighting examples of good practice (although it does not claim to provide an exhaustive list of the disclosure requirements).

For this study, Mazars analysed the IFRS financial statements published at 31 December 2013 by Corporates from the CAC 40 and Euro Stoxx 50 indices whose reporting period coincides with the fiscal year (banks and insurance companies are therefore excluded from the sample). The sample comprised 54 European Corporates representing different sectors.

This study can be viewed and downloaded at the following address:
http://www.mazars.com/Home/News/Our-publications/Mazars-Insights/IFRS-10-IFRS-11-and-IFRS-12-in-financial-reporting

We hope that this document will be useful in the context of the preparation of the interim and annual financial information for 2014.

Frequently asked questions

IFRSs

- Classification as assets held for sale where an entity receives a purchase offer.
- Accounting treatment of trade name acquired in the course of a business combination which the acquirer does not wish to retain.
- Scope of the venture capital entity exemption in IAS 28
- Accounting for the impacts of dilution in an associate.

Forthcoming meetings of the IASB, the IFRS Interpretations Committee and EFRAG

IASB	Committee	EFRAG
17 to 25 July 2014	15 and 16 July 2014	14 to 16 July 2014
18 to 25 September 2014	16 and 17 September 2014	2 to 5 September 2014
16 to 24 October 2014	11 to 12 November 2014	8 to 10 October 2014

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