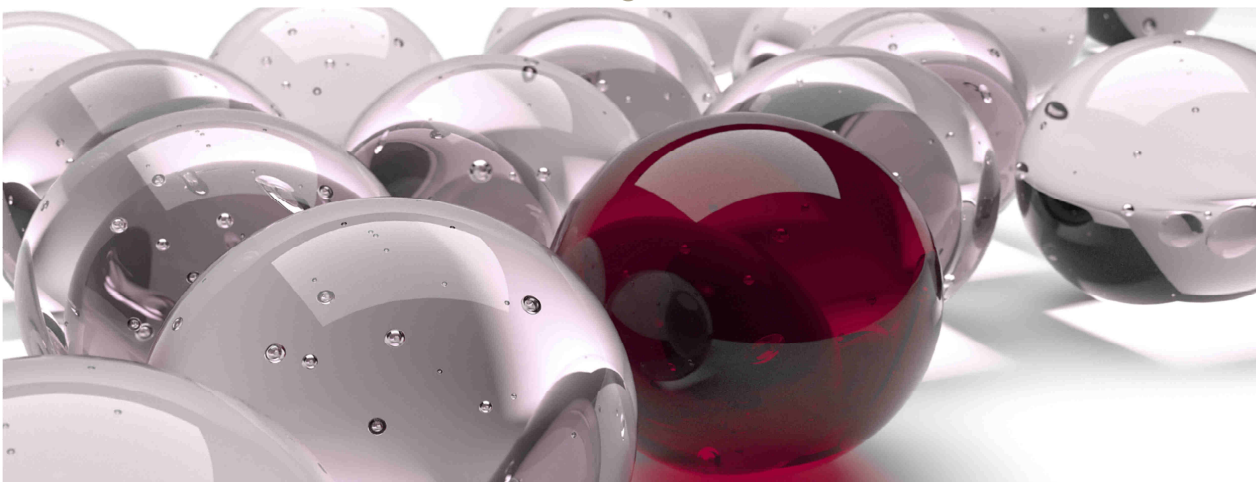


Beyond the GAAP

No 87 – March 2015

Mazars' newsletter on accounting standards



Summary

Highlights

IFRS	page 2
European highlights	page 2

A Closer Look

Leases: curtain falls on redeliberations	page 4
IFRS 15 and Topic 606: IASB and FASB continue to discuss practical implementation issues	page 11

Events and FAQ

page 14

Editors-in-chief:

Michel Barbet-Massin, Edouard Fossat

Columnists:

Carole Masson and Arnaud Verchère

Contact us:

Laurence Warpelin, Head accounting standards
laurence.warpelin@mazars.ch
Tél. : +41 21 310 49 03

Denise Wipf, Director
denise.wipf@mazars.ch
Tél. : +41 44 384 93 75
www.mazars.ch

Editorial

As rumoured over the past few weeks, the FASB is to publish a draft amendment proposing to defer the mandatory effective date of Topic 606, the US equivalent of IFRS 15. This decision will put pressure on the IASB to decide whether it will also defer the effective date. Meanwhile, much discussion continues over potential amendments to the two standards.

As regards the *Leases* project, the IASB has asked its staff to devote themselves to drafting the final standard. The Board has now finished its redeliberations, and is still hoping to publish the standard by the end of 2015.

At this key stage in the proceedings, Beyond the GAAP has decided to present a full overview of the decisions taken by the Board since the publication of the second exposure draft in 2013. We hope that this review will give readers a better understanding of the impact that the new standard on lease accounting will have on financial statements.

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

IFRS

TRG holds fourth meeting

On 30 March 2015, the TRG met again to discuss issues raised by stakeholders regarding implementation of IFRS 15.

The key questions discussed by the TRG at its fourth meeting related to the following issues:

- Series of distinct goods or services;
- Consideration payable to customers;
- Warranties;
- Significant financing components;
- Allocation of the transaction price to performance obligations in the event of variable consideration;
- Accounting for a customer's exercise of a significant right to acquire additional goods or services;
- Partial satisfaction of performance obligations prior to a contract with a customer (as defined in IFRS 15) meeting the criteria for identifying a contract set out in Step 1 of the standard.

The next issue of *Beyond the GAAP* will include an unofficial summary of the discussions. The official summary will be published by the IASB and FASB staff before the next TRG meeting, scheduled for 13 July 2015.

Deferral of effective date for the *Revenue* standard: will the IASB follow the FASB's lead?

At a meeting on 1 April 2015, the FASB (tentatively) decided to defer the effective date of Topic 606 by one year. Topic 606 is the converged standard published at the same time as IFRS 15. Listed entities will therefore be required to implement the standard for reporting periods commencing on or after 15 December 2017 (as opposed to 15 December 2016, as previously). A proposed Accounting Standards Update (ASU) is to be published, and will be open for comment for 30 days.

The IASB is expected to make a decision on whether it will defer the effective date of IFRS 15, which is currently set at 1 January 2017. It remains to be seen whether the IASB will follow in the FASB's footsteps.

European highlights

EFRAG recommends endorsement of IFRS 15 with effective date as determined by IASB

In March 2015, EFRAG recommended to the European Commission that IFRS 15 be endorsed in the EU.

Readers will remember that IFRS 15 was published by the IASB in May 2014 and will replace the current revenue recognition standards (IAS 11 and IAS 18) and related interpretations as of 1 January 2017. The standard is almost identical to Topic 606, which was published concurrently by the FASB.

EFRAG stated that it had assessed whether or not it would be advisable to defer the date of EU adoption. It concluded that it would be better to retain the effective date as stated in the published standard, for the following reasons:

- A deferral could reduce the comparability of financial statements within Europe, in that some companies would opt for early application while others would defer implementation until 1 January 2018;
- A deferral from the date stated by the IASB could also reduce comparability with companies outside Europe;
- Many companies have already started work on transition in order to be ready for the changeover at 1 January 2017. Interrupting this momentum could be counter-productive. Moreover, this work permits any practical difficulties in implementation to be identified as early as possible, allowing time for European organisations to raise issues with the IASB.

However, EFRAG also notes that it will keep a close eye on the discussions around IFRS 15, as amendments are expected before 1 January 2017 (cf. the February 2015 issue of *Beyond the GAAP*, and the article in this issue on the joint IASB/FASB meeting in March).

The effective date as determined by the IASB may also be changed in the near future. The IASB may decide to follow in the footsteps of the FASB, the American standard-setter, which has tentatively decided to defer the mandatory effective date by one year.

In this case, EFRAG would alert the European Commission so that it can take account of any changes that might affect the effective date in Europe.

The adoption of IFRS 15 by the EU is scheduled for the third quarter of 2015.

Report on European regulators' activity in 2014

On 31 March 2015, ESMA published a report on regulators' activity within the European Union (EU) in 2014.

The report states that regulators examined around 1,500 sets of IFRS financial statements (interim or annual), out of 6,400 issuers listed on EU regulated markets (thus, about a quarter of issuers). These checks resulted in 306 cases in which corrective action was required of the issuers (21 required to reissue the financial statements, 90 required to publish a corrective note and 195 required to present a correction in future financial statements). This was due to material departures relating to the presentation of financial statements, impairment of non-financial assets and accounting for financial instruments.

In the report, ESMA presents the quantitative and qualitative results of an assessment of the 2013 IFRS financial statements (interim or annual) of 176 issuers. The assessment focused on the areas identified as enforcement priorities for the 2013 financial statements, notably fair value measurement and impairment of non-financial assets.

The report is available on ESMA's website via the following link:

http://www.esma.europa.eu/system/files/2015-659_activity_report_on_accounting_enforcers_in_europe_in_2014.pdf

European Commission nominates new President of EFRAG

On 19 March 2015, the European Commission announced its decision to appoint Mr Wolf Klinz as President of the new EFRAG (for more details on the new organisational structure of EFRAG, see the January 2015 issue of Beyond the GAAP).

Mr Klinz will take office once his nomination has been approved by the European Parliament and Council, and ratified by the General Assembly of EFRAG.

Become a Subscriber

Keep up to date with international accounting with the English edition of Mazars' Newsletter on accounting standards entitled

Beyond the GAAP

Beyond the GAAP is a totally free newsletter. To subscribe, send an e-mail to doctrine-mazars@mazars.fr mentioning:

The name and first name of the people to whom you would like to send Beyond the GAAP;

Their position and company;

Their e-mail address.

A Closer Look

Leases: curtain falls on redeliberations

At the close of its March 2015 meeting, the IASB declared an end to its redeliberations on the draft *Leases* standard (which was re-exposed in May 2013). It also stated that it was satisfied that the due process criteria had been met, and as a result it was not felt necessary to re-expose the draft again. The IASB therefore asked its staff to focus on drafting the final standard, with a view to publication in the second half of 2015.

As the process of developing the standard has been particularly long and has involved many changes of tack, it is likely that many interested parties have lost track of the discussions. We therefore felt it would be useful to anticipate publication of the new standard with a review of the expected key points. This will allow all issuers of financial statements to assess the likely impact of the new standard on their financial statements, and to start preparing for this right away.

The following review is targeted particularly at lessees, as the impact on their financial statements will be greatest. There is no doubt that lessors will also have kept a weather eye on this project, which affects the very heart of their business. However, in practice, the new standard is not expected to have a significant impact on their financial statements. The IASB has decided to retain the current models for lessor accounting, and to use classification criteria very similar to those in the current IAS 17 to determine which accounting model should be used.

1. What is the expected scope?

The standard will apply to all contracts that meet the definition of a lease, with the following exceptions:

- leases of intangible assets in the financial statements of lessees, with the option of applying the standard if the lessee wishes (accounting policy choice);
- leases relating to the exploring for or to the use of mineral resources (mined materials, natural gas, etc.), which fall within the scope of IFRS 6;
- leases of biological assets, which fall within the scope of IAS 41;
- and service concession arrangements within the scope of IFRIC 12.

2. How is a lease expected to be defined?

Since the first publication of a Discussion Paper in March 2009, the IASB has favoured a model that requires lessees to recognise all leases in the balance sheet. Thus, under the future standard, whether or not a lessee recognises a lease asset and liability in the balance sheet will depend on whether a contract is a lease or a service contract. This is different from the previous model, which distinguished between operating leases and finance leases.

A document entitled 'Project Update', which was published by the IASB staff last February, summarises the Board's decisions on this subject and is expected to serve as a basis for drafting the final standard.

A more precise definition of a lease

The expected definition of a lease is: a contract that conveys to the customer the right to use an asset for a period of time, in exchange for consideration.

For a lease to exist, the contract must give the customer control over how the asset is used.

Control over the use of an asset exists when the customer:

- has exclusive use of the asset for the contractual term; and
- can decide how to use it.

The document published by the IASB staff in February provides useful clarification on how this definition should be applied.

The contract relates to an identified asset

The asset to which the contract relates must be explicitly or implicitly identified. There is no identified asset if the supplier has a substantive right to substitute the asset during the contractual term.

The supplier is deemed to have a substantive right to substitute the asset if both of the following conditions are met:

- there are no technical or economic barriers to substitution; and
- the supplier has an economic incentive to substitute the asset.

The contract conveys exclusive right to use the asset

This criterion is met if the customer obtains substantially all the economic benefits resulting from use of the asset during the contractual term.

The customer directs the use of the asset

The customer must have the ability to decide when, how and for what purpose the asset is used during the contractual term.

For example, if the customer decides where and when a leased ship sails, and the nature of the merchandise transported, it directs the use of the asset.



Illustrative examples

These various criteria are illustrated by six examples in the Project Update. Each example sets out the reasoning used to classify a contract as a lease or a service contract.

The fact that a ship’s crew is employed by the supplier does not make the contract a service contract – provided that the customer has the ability to decide when, where and for what purpose the ship is used. In this case, the contract would comprise both a lease (the transfer of the right to use the ship) and a service contract (providing the crew). Similarly, if a truck lease requires the lessee to return the truck to the manufacturer for maintenance at regular intervals, this does not make the contract a service contract, provided that the customer has the ability to decide how the item is used at all other times.

Distinguishing between a lease and a service contract: now a critical issue

Although in many cases the distinction between a lease and a service contract will be obvious, we can expect to see much debate on this subject in the future. The response to this question will determine whether or not a contract is recognised in a lessee’s balance sheet:

- For all leases, the new model requires the lessee to recognise lease assets and liabilities on the balance sheet.

- In contrast, service contracts are not capitalised on the balance sheet: they are deemed to be enforceable contracts under which the customer and supplier fulfil their obligations over time.

3. How are lease and non-lease components to be separated?

Once it has been determined that a contract includes a lease component, the separate components of the contract must be identified so that they can be accounted for separately.

The consideration is allocated based on the relative observable standalone prices of the components of the contract. If observable information on standalone prices is not available, the lessee shall estimate the standalone prices of the contract components. This method of allocating consideration is in line with the requirements of IFRS 15.

Finally, if a contract comprises lease and non-lease components, the Boards propose to give lessees the option of accounting for the entire contract as a lease, instead of separating lease and service components.

This option (accounting policy choice) would be applicable for each class of assets.

4. How is the lease term to be determined?

Initial measurement

The lease term is expected to be defined as the non-cancellable period during which the lessee has the right to use the underlying asset.

This period will include periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option:

- the entity shall take account of all relevant factors that create an economic incentive to exercise or not to exercise an option;
- options shall be taken into account if it is “reasonably certain” that the lessee will exercise them, which is a high threshold of probability.

An option to terminate a lease should only be taken into account when determining the lease term if there are no economic barriers that would constitute a significant economic incentive not to exercise the option.

Subsequent reassessment

The lease term shall only be reassessed by the lessee upon the occurrence of a significant event or change in circumstances, or resulting from an action or decision taken by the lessee. This might be the case, for example, if the lessee made substantial improvements to the underlying asset during the lease term, giving it an incentive to renew the lease.

In contrast, a significant change in market conditions during the lease term, resulting in an increased probability of exercising an option, would not give rise to a reassessment of the lease term.

5. What is the proposed accounting model for lessees?

Measurement

As noted previously, the IASB's main objective was to develop a model that would require lessees to recognise all leases on the balance sheet.

Under this model, each lease would give rise to the recognition of a right-of-use asset, representing the lessee's ability to use the asset during the lease term, and a lease liability, for the discounted present value of lease payments.

Discount rate

The standard is expected to state that the lessee should use the rate charged by the lessor to the lessee for discounting lease payments. If that rate cannot be easily determined, the lessee should use its incremental borrowing rate (the rate of interest that the lessee would have had to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset with a similar value to the leased asset, in a similar economic environment).

It should be noted that the discount rate should be reassessed if there is a change to either the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

Variable lease payments

The future standard is expected to make a distinction between variable lease payments that depend on the use or performance of an asset, and variable lease payments that depend on an index or rate.

Variable lease payments that depend on the use or performance of the asset (e.g. percentage of revenue) should not be taken into account in measurement. They should be recognised in profit or loss as they are incurred.

However, variable lease payments that depend on an index or rate should be taken into account in initial measurement of lease assets and liabilities.

Initial direct costs

Initial direct costs are those which would not have been incurred in the absence of the lease (e.g. commissions paid to obtain the lease). They are included in the initial measurement of the right-of-use asset.

Subsequent measurement

The IASB decided on a single approach for subsequent measurement of all leases. Under this approach, a lessee would recognise amortisation of the right-of-use asset separately from interest on the lease liability.

The lessee would thus amortise the right-of-use asset over the lease term, usually on a straight-line basis, and would recognise the lease liability on an amortised cost basis.

Under this model, the total lease expense (amortisation + interest) would decrease over the lease term.

This would mean there is no longer a distinction, in lessee accounting, between finance leases and operating leases. This is a change of tack from what was proposed in the 2013 exposure draft. However, the distinction is to be retained in lessor accounting for leases, although the terminology has changed to "Type A leases" (formerly finance leases) and "Type B leases" (formerly operating leases).

6. How should leases be presented in the financial statements?

Having opted for a single model of lease accounting for lessees, the IASB reached the following conclusions on the presentation of leases in the financial statements:

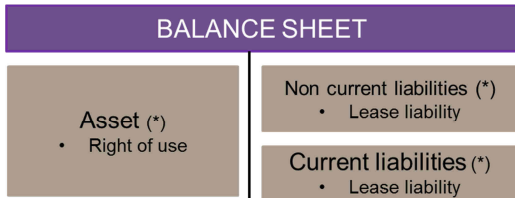
Balance sheet

Right-of-use assets should be presented as follows:

- either in the same line item as other assets which are owned, with further details in the notes on which line items include right-of-use assets;
- or as a separate line item (or items), if that would result in a clearer understanding of the entity's financial situation.

Lease liabilities should be accounted for in line with the requirements of IAS 1 on the presentation of financial liabilities:

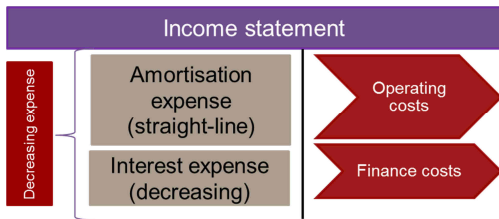
- The lease liability should be presented as a separate line item, or disaggregated into classes and presented as separate line items if that would result in a clearer understanding of the entity's financial situation.
- The liability should be broken down into current and non-current components, according to when the payments fall due.



(*) Separate line item or split into more than one line item

Income statement

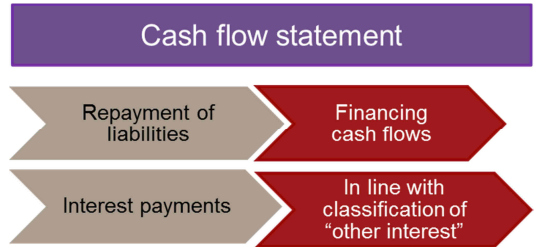
Amortisation of the right-of-use asset and interest on the lease liability should be presented separately, in operating income (expense) and financial income (expense) respectively.



Cash flow statement

To retain the link between the balance sheet, income statement and cash flow statement, the IASB finally decided that cash flows relating to leases should be presented as follows:

- cash payments for the principal portion of the lease liability should be presented within financing activities; and
- cash payments for the interest portion of the lease liability should be presented either in operating activities or financing activities, depending on how the entity has presented other interest payments, in line with the requirements of IAS 7.



7. What disclosures should be presented in the notes?

In the course of its redeliberations, the IASB defined the key objective of disclosures in the notes: "To enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases."

In addition to the qualitative disclosures necessary to meet the objective cited above, entities will be required to present the following quantitative disclosures on their leases:

- Amortisation of right-of-use assets, broken down by class of underlying assets;
- Financial expenses relating to the lease liability;
- Lease payments on short-term leases;
- Lease payments on small assets;
- Variable lease payments;
- Total cash flows relating to leases.

Finally, lessees will be required to present a maturity analysis of lease liabilities, in line with IFRS 7, separately from the maturity analysis of other financial liabilities.

8. How will sale and leaseback transactions be accounted for?

During the redeliberation process, the IASB decided to provide clarification on the accounting treatment to be used for sale and leaseback transactions (in which an entity sells an asset and subsequently leases it back from the buyer-lessor).

How shall an entity determine whether a sale has occurred?

The future standard is expected to state that the criteria set out in IFRS 15 should be used to determine whether a sale has occurred. It will specify that the existence of a leaseback does not in itself preclude an entity from concluding that a sale has occurred. Conversely, if a seller-lessee has a substantive repurchase option then no sale has occurred (as the seller-lessee has not lost control of the asset).

If no sale has occurred, the transaction should be treated as a financing transaction.

How should gains and losses on such a sale be accounted for?

Under the future standard, the accounting treatment will differ depending on whether the entity has realised a gain or a loss on the sale in a sale and leaseback transaction.

The future standard is expected to state that:

- a loss should be recognised immediately by the seller-lessee;
- a gain should only be partially recognised. The entity should only recognise the portion of the gain that relates to the residual interest in the underlying asset at the end of the leaseback. This is because it is only the residual interest in the underlying asset, and not the totality of the underlying asset, that has been sold, since the seller-lessee retains the right to use the underlying asset for the lease term. Thus, only this portion of the gain shall be recognised (the portion of the gain relating to the retained right-of-use may not be recognised).

Transactions at “off-market” terms

An entity shall determine whether or not the transaction price is at-market.

In order to do this, depending on which is most readily measurable, it should compare either:

- the sale price and the fair value of the underlying asset; or
- the discounted present value of lease payments and the discounted present value of market lease payments.

Any off-market adjustment should be treated as:

- a prepayment of rent, if there is a shortfall compared with at-market prices (the transaction is under-valued);
- additional financing, if there is an excess compared with at-market prices (the transaction is over-valued).

9. What accounting treatment should be used for lease modifications?

Similarly to IFRS 15, the future *Leases* standard is expected to set out requirements on lease modifications and how to account for them.

What will a lease modification be?

The future standard is expected to define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. It should be noted that the IASB has also tentatively decided that the substance of the modification will take precedence over the form.

How should a lease modification be accounted for?

Under the future standard, a lease modification shall be accounted for by lessees as a new lease (separate from the original lease), when:

- the lease grants the lessee an additional right-of-use not included in the original lease; and
- the additional right-of-use is priced commensurate with its standalone price.

Any lease modification that does not meet these criteria (i.e. is not accounted for as a new lease), but that results in a change in the scope of the original lease, shall be accounted for as follows:

- the lessee shall remeasure the lease liability, using a discount rate determined at the date of the modification;
- the lessee shall make a corresponding adjustment to the amount of the right-of-use asset.

A lease modification that increases the scope of the lease, or the amount of consideration paid, shall result in an increase in the value of the right-of-use asset by an amount corresponding to the remeasurement of the lease liability.

A lease modification that reduces the scope of the lease, or the amount of consideration paid, shall result in a decrease in the carrying amount of the right-of-use asset (to reflect the partial or total sale) and recognition of a gain or loss proportionate to the decrease in scope.

10. How will subleases be accounted for?

The future standard is expected to stipulate that an intermediate lessor (an entity that is both a lessee and a lessor of the same underlying asset) should account for the head lease and the sublease as two separate contracts, unless they meet the contract combinations criteria:

- the head lease shall be accounted for like any other lease under the general rules on lessee accounting;
- the sublease shall be accounted for like any other lease under the general rules on lessor accounting. Whether the sublease is classified as a Type A or Type B lease shall be determined with reference to the right-of-use asset arising from the head lease, rather than with reference to the underlying asset itself.

Finally, the future standard is expected to stipulate that intermediate lessors should not offset:

- lease assets and liabilities arising from a head lease and a sublease that do not meet the requirements for offsetting;
- lease income and expense related to a head lease and a sublease respectively, unless the entity is acting as an agent as defined in IFRS 15.

11. Will there be any exemption and simplification options?

Throughout the project, the IASB has faced criticisms for the complexities involved in implementing the proposed model. Some observers felt that the potential improvements to the financial statements were not worth the cost of implementation.

The IASB thus decided to introduce some exemption and simplification options for short-term leases, small asset leases and recognition at the portfolio level.

Short-term contracts

Lessees may elect to apply the exemption from recognising lease assets and liabilities for short-term leases.

A lease is deemed to be 'short-term' if it does not exceed **12 months, including lease extension options where there is an economic incentive to exercise the option.**

Small asset leases

Small asset leases are also eligible for an exemption from recognition in the lessee's balance sheet.

To qualify as small assets, leased assets must not be dependent on, or highly inter-related with, other assets that do not qualify as small assets.

The IASB is planning to include a discussion in the Basis for Conclusions of what it had in mind when it introduced this exemption. In other words, it is planning to give an indication of the order of magnitude that it had in mind for an asset to qualify as 'small' (if one goes by the figure mentioned in the Board's discussions, this is likely to be around \$5,000 per asset).

Recognition at the portfolio level

A practical expedient will be introduced whereby an entity that leases a large number of small assets within a master lease agreement may opt to recognise the right-of-use assets and lease liabilities on a portfolio level rather than individually. This option should make the accounting treatment for multiple small-ticket leases much less onerous.

Lessors will also be permitted to apply this simplification option.

12. What will the transition requirements be?

Definition of leases

The transition requirements are expected to permit entities to grandfather the definition of a lease for all contracts that are ongoing at the date of initial application of the new standard. If an entity opts to do this, it should disclose the fact in the notes.

Transition options

The IASB has decided to give lessees a choice between two transition approaches:

- a full retrospective approach; or
- a modified retrospective approach.

It should be noted that the chosen approach must be applied consistently across the entire portfolio of ongoing leases at the transition date.

What would the modified approach be?

Under the modified retrospective approach, the lessee:

- would not restate comparative information. The date of initial application would be the first day of the reporting period in which the lessee applies the new standard;
- would recognise the cumulative effect of the change in approach as an adjustment to the opening balance of retained earnings at the date of initial application;
- would measure the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application;
- would have the choice, for each lease, between the following two approaches for measurement of the right-of-use asset:
 - retrospective measurement as if the new standard had always been applied, using a discount rate based on the lessee's incremental borrowing rate at the date of initial application; or
 - measuring the right-of-use asset at an amount equal to the lease liability, adjusted for any previously recognised prepaid lease payments;
- would be permitted to apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
- would be permitted to adjust the right-of-use asset by the amount of any previously recognised onerous lease provision, as an alternative to performing an impairment test;
- would be permitted to apply an exemption from restating leases for which the term ends within 12 months (or less) of the date of initial application. These leases would then be recognised as short-term leases;
- would not be required to include initial direct costs in the measurement of the right-of-use asset;
- would be permitted to use hindsight when applying the new standard for the first time, for example in determining the lease term if the contract contains options to extend or terminate the lease.

Conclusion

The new *Leases* standard, which is scheduled for publication by the end of the year, will mark a turning point in the way that leases are measured and recognised. It will have a potentially major impact on the financial statements of lessees, due to the new requirement that all leases should be recognised in the balance sheet.

This will therefore have an effect on the key ratios used by entities (debt, return on assets, EBITDA, operating margin, etc.), which may in turn require the review of some banking covenants.

The mandatory effective date of the standard is not yet known (the IASB must ensure that entities have enough time to ensure compliance with the standard) and the standard will also have to undergo the European endorsement process. However, it is never too early for entities to start preparing for initial application.

Key points to remember

Lessor accounting

1. Accounting model largely unchanged
2. Finance leases and operating leases are now known as Type A leases and Type B leases, respectively

Lessee accounting

1. For all leases, a right-of-use asset and a lease liability must be recognised in the balance sheet
2. The total lease expense decreases over the lease term due to the interest expense, and is presented under EBITDA
3. Variable lease payments that depend on the use of the leased asset are not taken into account in the lease liability
4. Some contracts may be classified as service contracts and not recognised in the balance sheet. An in-depth analysis should be carried out in order to identify these contracts.
5. Many concepts are addressed in a similar way to IFRS 15, notably the concept of control, the accounting treatment for lease modifications, and the allocation of consideration between different components.
6. Short-term leases and small asset leases are optionally exempt from recognition in the balance sheet
7. Increased disclosures are required in the notes
8. The transition requirements give entities the option of not using the full retrospective approach

A Closer Look

IFRS 15 and Topic 606: IASB and FASB continue to discuss practical implementation issues

In the wake of the February 2015 discussions between the IASB and FASB (cf. Beyond the GAAP February 2015), the two Boards have continued to debate the practical issues relating to implementation of the new *Revenue Recognition* standard. These issues were identified in previous meetings of the Transition Resource Group (TRG).

The following topics were discussed at the March 2015 meeting:

- Additional practical expedients for transition;
- Sales tax presentation (i.e. gross or net revenue?);
- Non-cash consideration from customers;
- Collectability considerations (Step 1 in the model presented in the standard: identifying the contract with a customer);
- Determining whether an entity is acting as a principal or as an agent.

As was the case last month, the Boards frequently reached different decisions, with the IASB retaining a principle-based approach while the FASB sought to clarify individual points, or even reintroduce requirements that had previously formed part of the US accounting framework but that had not been included initially in Topic 606 (which was published concurrently with IFRS 15).

While IFRS 15 and Topic 606 are still broadly converged, the two documents are beginning to differ in their details. The due process is not yet complete, and thus the decisions presented below are still tentative.

The FASB has decided to issue another proposed Accounting Standards Update to reflect the decisions made in March. The IASB is sticking with its strategy of incorporating the proposed amendments to IFRS 15 (all of which are minor so far) into a single exposure draft. The vote on the content of this exposure draft is still scheduled for June 2015. The IASB expects that the amendments will be finalised by the end of the year.

1. Additional practical expedients for transition

Contract modifications

At its January 2015 meeting, the TRG discussed potential challenges identified by stakeholders regarding restatement of contract modifications that took place prior to initial application of the standard, where the full retrospective approach was used. For more details on this issue, see the January 2015 issue of Beyond the GAAP.

At the March 2015 joint meeting, the IASB and FASB discussed new practical expedients that could be added to the standard to simplify the transition requirements.

The two Boards agreed on a practical expedient for modified contracts, to be implemented at the contract modification adjustment date (CMAD) as follows:

- The entity identifies all the satisfied and unsatisfied performance obligations in the contract at the CMAD, reflecting all contract modifications from inception to the CMAD;
- The entity then determines the transaction price at the CMAD, similarly reflecting all contract modifications from inception to the CMAD;
- Finally the entity allocates the transaction price to the performance obligations identified at the CMAD (whether or not they have been satisfied) based on the historic standalone selling price of each underlying good or service.

This practical expedient means that an entity would only have to perform a single price allocation, with the benefit of hindsight, as the transaction price would be determined in such a way as to reflect all contract modifications since inception. This expedient would release entities from the obligation to measure the impact of all contract modifications separately or sequentially. After the CMAD, contract modifications would be recognised in line with the new *Revenue Recognition* standard. The telecoms sector in particular should benefit from this practical expedient.

This option would be available to entities using either the full retrospective method or the modified retrospective method.

The IASB decided that the CMAD would be the beginning of the earliest period presented, irrespective of the method used. Thus, the CMAD would be 1 January 2016 if a single comparative period were presented, for initial application of IFRS 15 at 1 January 2017.

It should be noted that the FASB decided that the CMAD would be the date of initial application for entities using the modified retrospective method.

Completed contracts

Readers will remember that the new *Revenue Recognition* standard defines a completed contract as a contract for which the entity has fully transferred all of the goods or services identified in accordance with IAS 11 *Construction Contracts*, IAS 18 *Revenue*, and the related interpretations.

The IASB decided to grant an additional practical expedient to entities in order to simplify transition, allowing entities that opt for the full retrospective method to apply IFRS 15 retrospectively only to contracts that are not completed at the beginning of the earliest period presented. A similar practical expedient had already been proposed for entities using the modified retrospective method, permitting entities to only restate contracts that are not completed as of the date of initial application. As a result, the comparative periods presented will not be comparable as they will be presented in line with IAS 11, IAS 18 and the related interpretations.

The staff paper gives an example of a contract that would be considered to be completed under the current standards but not under the new *Revenue Recognition* standard. The example given is that of a retailer who sells a product to a customer and also provides the customer with a material right relating to the acquisition of another product (e.g. a significant discount on the customer's next purchase). Under IAS 18, the contract is *a priori* considered to be completed once the first product has been delivered, as there are no further deliverables falling within the scope of the contract. Under IFRS 15, if the customer is granted a material right that would not have been provided without the initial purchase, an amount of revenue should be deferred that is commensurate with the option to acquire an additional product. The deferred revenue is not recognised until the option is exercised or expires.

The FASB decided not to add a similar practical expedient to Topic 606.

If either or both of the above practical expedients are used, an entity must present the disclosures required by paragraph C6 of IFRS 15, namely:

- the expedients that have been used;
- a qualitative assessment of the estimated effect of applying each of the expedients, to the extent that this is reasonably possible.

2. Sales tax presentation (i.e. gross or net revenue?)

This issue was discussed at the first meeting of the TRG in July 2014 (cf. *Beyond the GAAP* October 2014). At that time, the TRG concluded that the new *Revenue Recognition* standard provided sufficient guidance on the issue. Subsequently, stakeholders in the US have asked the FASB staff for a practical expedient in line with the current US guidance on the subject. This gives entities an accounting policy choice for the presentation of certain types of sales tax (i.e. whether or not to include them in revenue).

The FASB thus decided to provide a practical expedient that would permit entities applying Topic 606 to present amounts collected from customers for certain taxes on behalf of a State or other in revenue, net of the related amounts subsequently remitted to the State in question. In practice, this means that the amounts remitted to the State would be excluded from the determination of the transaction price. If an entity did not apply this practical expedient, it would need to carry out an analysis in line with Topic 606 to determine whether or not these taxes should be included in the transaction price.

The IASB decided not to introduce a similar practical expedient, as IAS 18 already stipulates the accounting treatment of amounts collected on behalf of third parties and IFRS 15 does not introduce any new requirements. Stakeholders should thus already have experience in carrying out this kind of analysis.

3. Non-cash consideration from customers

The decisions made on this subject address issues previously discussed at the January 2015 meeting of the TRG (cf. *Beyond the GAAP* January 2015).

The two questions raised by stakeholders were as follows:

- At what date should the amounts received/receivable in a form other than cash be measured?
 - At contract inception?
 - When the non-cash consideration is received (or is receivable)?
 - At the earlier of (i) when the non-cash consideration is received (or is receivable) and (ii) when the related performance obligation is satisfied (or as it is satisfied over time)?
- How should the guidance on the constraint on estimates of variable consideration be applied, when the fair value of non-cash consideration might vary due to both the form of the consideration and for reasons other than the form of the consideration?

At this stage, IFRS 15 and Topic 606 required entities to measure non-cash consideration received (or receivable) at fair value, without giving any further details. The TRG's discussions showed that divergent practices were likely to occur if the new standard did not clarify the issue. However, the IASB staff noted in Agenda Paper 7C, prepared for the March 2015 meeting, that differences in practice were no more likely under IFRS 15 than they already were under IAS 18. Under US GAAP, in contrast, there are currently specific requirements for the recognition of non-cash consideration.

The FASB decided at the March meeting to stipulate that non-cash consideration should be measured at contract inception. It also decided to clarify Topic 606 to specify that the guidance on the constraint on estimates of variable consideration should only be applied to variability of non-cash consideration resulting from reasons other than the form of the consideration.

Meanwhile, the IASB decided that it would not modify IFRS 15 (either the body of the text or Illustrative Example 31, which relates to this subject). The IASB also noted that the approach tentatively decided by the FASB would not be the only acceptable interpretation of IFRS 15. The IASB may reconsider this issue in the post-implementation review of IFRS 15.

In practice, an entity which is listed in both Europe and the US could apply the guidance of Topic 606 while remaining compliant with IFRS 15, which is less prescriptive on this issue.

4. Collectability considerations (Step 1 in the model presented in the standard: identifying the contract with a customer)

This issue was also previously discussed at the January 2015 meeting of the TRG (cf. Beyond the GAAP January 2015). One of the questions raised in practice was: what happens in the case of a contract for which the revenue was assessed as collectable at contract inception, and subsequently reassessed as probably not collectable?

The members of the TRG noted that the new standard was clear on the fact that one of the essential conditions for identifying the existence of a contract with a customer (and hence for having the right to recognise revenue) is that it is probable that the entity will collect the consideration to which it is entitled in exchange for the goods or services that will be transferred to the customer. If this criterion is not fulfilled, the amounts received from the customer are not recognised as revenue unless the contract is completed or terminated and the consideration received from the customer is not refundable. This might seem punitive, particularly in the event that an entity cannot terminate a contract and is obliged to continue providing the promised service.

It should be noted that the IASB staff stated in Agenda Paper 7D, which was prepared for the March meeting, that it would be relatively rare for a contract not to meet the criteria set out in Step 1 of the standard, specifically the collectability threshold.

The IASB did not vote on this issue in the March meeting. It will decide at a future date on whether, and if so how, to modify IFRS 15 in order to clarify the requirements of the standard.

The FASB, meanwhile, decided to amend Topic 606 in order to clarify:

- When a contract is 'terminated': this refers to a contract in which the entity has the ability to cease transferring additional goods or services to the customer, and has done so;
- The objective of the collectability threshold in Step 1 of the standard: this is intended to assess the entity's exposure to credit risk for the goods and services that will be transferred to the customer in the future.

5. Determining whether an entity is acting as a principal or as an agent

The issue of the agent/principal distinction was discussed by the TRG at its first meeting in July 2014 (cf. Beyond the GAAP October 2014). Since then, the staffs of the FASB and IASB have been researching the issue further, and the joint meeting in March provided an opportunity to update the Boards on the work to date.

Readers will remember that the key issue is as follows: while IFRS 15 carried over the indicators in the IAS 18 implementation guidance on the agent/principal distinction, it is not clear whether the previous conclusions should be reconsidered in the light of the general principle of the new standard. This states that an entity is a principal if it controls the promised good or service before its transfer to the customer. The implementation of this principle may be particularly complex in the case of Internet transactions involving intangible goods.

Neither of the Boards reached a decision on this subject. The discussion is to be continued at the May meeting, with a view to including any proposed minor amendments to IFRS 15 in the exposure draft to be finalised at the June 2015 meeting.

Key points to remember

1. The IASB and FASB differed in their decisions on the following issues:
 - the implementation dates for simplified transition requirements relating to contract modifications and contracts that are completed by the beginning of the earliest period presented;
 - whether to make clarifications to the standard relating to the inclusion of sales tax in revenue, non-cash consideration, and collectability considerations. The FASB was in favour of making clarifications, while the IASB was not.
2. The Boards need to engage in further discussion on the concept of control, to determine whether an entity is acting as a principal or as an agent.

Events and FAQ

Frequently asked questions

IFRSs

- Whether or not “take or pay” guarantees paid by joint venturers should be taken into account in cash flows used for impairment tests;
- The impact of “economic hedging” of stock option plans on the calculation of earnings per share;
- Recognising deferred assets corresponding to tax loss carryforwards during a period of “exceptionally” low prices;
- Impact on depreciation of the shutdown of an item of property, plant and equipment for renovation or modernisation.

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

IFRS		EFRAG	
IASB	Committee	Board	TEG
27-30 April	12-13 May	22 April	6-8 May
18-20 May	14-15 July	3 June	10-12 June
22-26 June	8-9 September	24 June	8-10 July

Beyond the GAAP is published by Mazars. The purpose of this newsletter is to keep readers informed of accounting developments. Beyond the GAAP may under no circumstances be associated, in whole or in part, with an opinion issued by Mazars. Despite the meticulous care taken in preparing this publication, Mazars may not be held liable for any errors or omissions it might contain.

The drafting of the present edition was completed on 15 April 2015.
© Mazars – April 2015 – All rights reserved