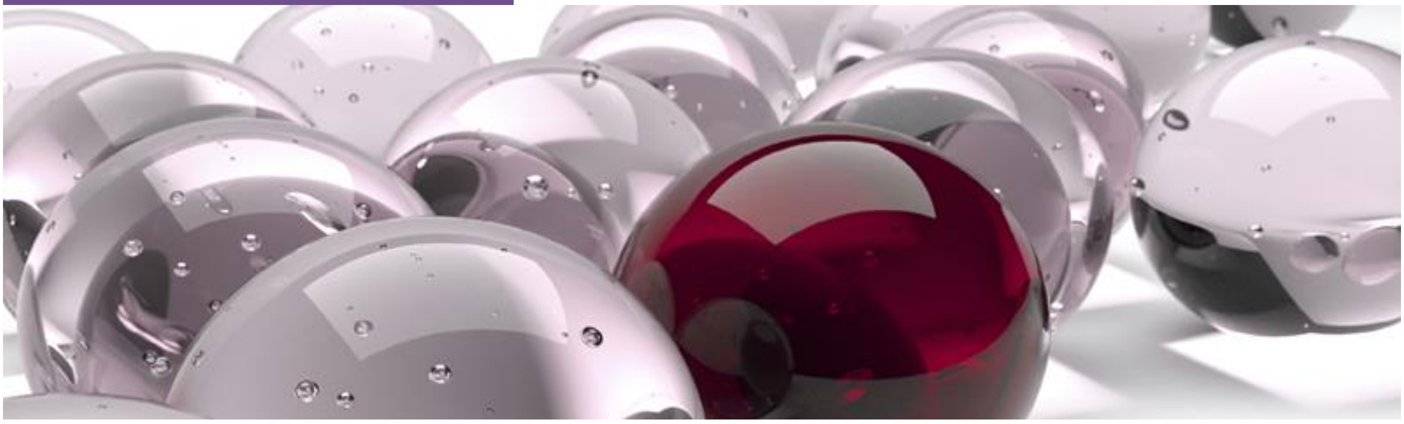
Beyond the GAAP

Mazars' newsletter on accounting standards

NEWSLETTER / No.103– September 2016



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Editorial

The IASB's update to its work plan on 23 September 2016 gives us a good idea of what is on the cards for IFRS over the next few months. In addition to the *Insurance Contracts* standard, which is scheduled for publication in March, and the *Conceptual Framework* (date not yet set), the next key milestones relate to research projects. Discussion Papers have been announced on business combinations under common control, dynamic risk management, financial instruments with characteristics of equity, and rate-regulated activities.

As well as these new long-term projects, the IASB has confirmed that it will publish interpretations on uncertainty over income tax treatments, and on foreign currency transactions and advance consideration. Then it will be time for the Post-implentation Review of the consolidation standards and of IFRS 13.

With no major changes scheduled over the next few years, following the implementation of IFRS 9, IFRS 15 and IFRS 16, the IASB, in the immediate future, will focus on maintenance of standards, through minor amendments, interpretations, annual improvements and decisions by the IFRS IC.

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

European Highlights

European Commission publishes report on the activities of the IFRS Foundation and EFRAG in 2015

On 8 September 2016, the European Commission published its first annual report to the European Parliament and Council on the activities of the IFRS Foundation, EFRAG and PIOB.

These annual reports are required under European regulations as these institutions are funded by the European Union.

For the IFRS Foundation and EFRAG, the European Commission lists their activities and achievements relating to standard-setting as well as to due process and governance.

In the section on the IFRS Foundation, the European Commission notes that accounting standards:

- take account of different business models – particularly IFRS 9 - *Financial Instruments* and IFRS 15 - *Revenue from Contracts with Customers*, which are currently undergoing the EU endorsement process;
- reflect the economic consequences of transactions: IFRS 15 and IFRS 16 - *Leases* reflect the consequences of transactions, and the Commission expects that this will also be the case for the future standard on insurance contracts;
- are not too complex: the Commission acknowledges that IFRS 9 is complex, but has also introduced simplifications. It notes that EFRAG is of the opinion that the standard is not so complex as to impair understandability of financial statements. IFRS 15 allows for better representation of the complexity of modern business transactions than the previous standard;
- avoid artificial short-term and volatility biases: here the Commission makes a positive comment on IFRS 15. It notes that the future standard on insurance contracts will also be examined to see if it achieves this.

The Commission also emphasises its support for the re-introduction of the concept of prudence to the IFRS Conceptual Framework, and notes that it will pay close attention to future IASB deliberations on the subject. It also welcomes the IASB's effects analysis of IFRS 16.

As regards EFRAG, the Commission states that it is now well equipped to fulfil its obligations. It has expanded its scope of assessment, particularly as regards the IAS Regulation's 'public good' criterion.

The Commission also welcomes EFRAG's work on analyses of the effects of IFRS, including macro-economic effects such as financial stability and economic development in Europe.

The Commission's report is available via the following link: https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/1-2016-559-EN-F1-1.PDF

EBA consults on draft guidelines for implementation and application of IFRS 9

The European Banking Authority (EBA) forms an integral part of the European System of Financial Supervision. Its role is to maintain financial stability and oversee the European banking sector.

As part of this, EBA works towards convergence between national enforcers, and is mandated to assess risks and weaknesses in the European banking sector.

In the context of these responsibilities, EBA has launched a consultation on the draft guidelines for implementation and ongoing application of the impairment phase of IFRS 9. The guidelines are primarily aimed at credit institutions, and EBA states that they aim to build on the guidance published by the Basel Committee in December 2015.

The definitive version of the guidelines will apply to credit institutions within the European Union.

EBA's consultation on the draft guidelines for credit risk management and accounting for ECLs was launched over the summer. The deadline for responding to the consultation is 26 October.

The consultation document is available via the following link: https://eba.europa.eu/news-press/calendar?p_p_id=8&_8_struts_action=%2Fcalendar%2Fview_event&_8_eventId=1532224

European Highlights

EFRAG study on goodwill

As part of the Post-implementation Review (PIR) of IFRS 3, EFRAG carried out a study of goodwill, in order to investigate when impairment losses were recognised and whether a ‘bubble’ has formed.

On 30 September 2016, EFRAG published the results of this quantitative study in a report entitled, “What do we really know about goodwill and impairment?” The objective was to facilitate the debate on the accounting treatment of goodwill by providing evidence on how goodwill has evolved over time.

EFRAG’s study presents a quantitative analysis of a sample of 328 European companies between 2005 and 2014. These European data are compared with data from the United States, Australia and Japan.

Key findings from the European data are as follows:

- The total amount of goodwill increased from €935bn to €1,341bn between 2005 and 2014, an increase of 43%;
- A small number of companies account for a large share of the carrying amount of goodwill;
- The ratio of goodwill to total assets has remained relatively stable over the period at around 3.7%. This ratio is significantly higher when entities in the financials industry are excluded, but has gradually fallen since 2009;
- The ratio of goodwill to net assets has been decreasing since 2008, but was still high in 2014 (29%);
- The amount of impairment losses recognised was at its highest in 2008 and 2011, when the performance of the financial markets was negative. On average, impairment losses represented 2.7% of the opening balance of goodwill;
- Impairment losses are significantly concentrated in a small number of companies, particularly in the telecoms and financials industries; and
- The absolute and relative levels of goodwill and impairment losses vary significantly across industries.

The study is available here:
http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520Quantitative%2520Study%2520Goodwill%25202016.pdf

IFRS Highlights

Death of Wayne Upton, chair of the IFRS IC

On 14 September 2016, the staff and Trustees of the IFRS Foundation and the IASB announced the sudden death of Mr Wayne Upton, Director of International Activities of the IASB and chair of the IFRS Interpretations Committee (IC).

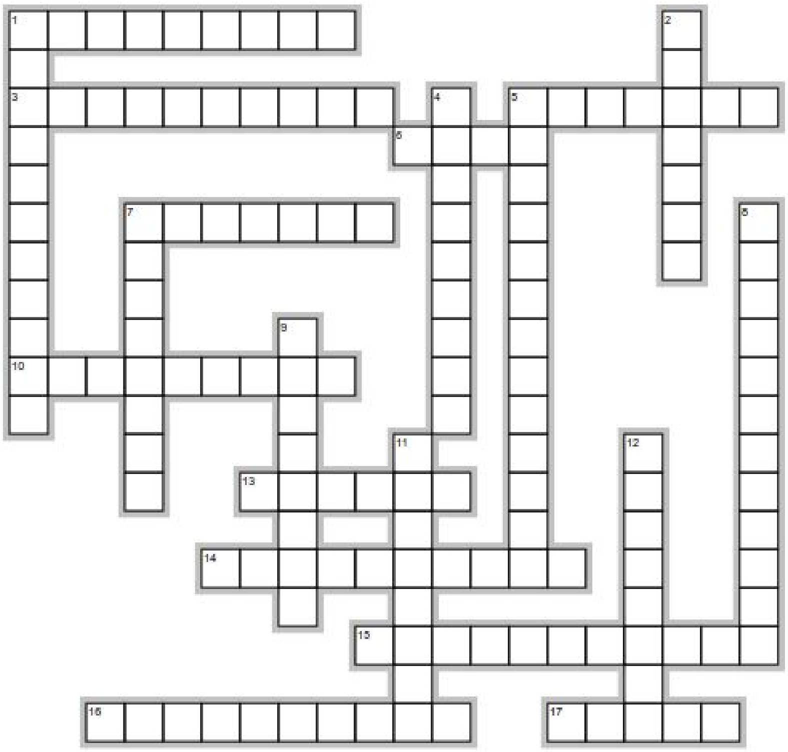
Wayne Upton joined the IASB as Research Director in 2001.

In 2008 he became Director of International Activities, playing an important role in supporting countries transitioning to IFRS.

In 2012, Mr Upton became chair of the IFRS IC. He also chaired the Emerging Economies Group and coordinated the Islamic Finance Consultative Group.

Crossword: last month’s solution

Crossword: The 20 "must knows" on revenue under IFRS 15!



Down:

1. Type of obligation that is the unit of account for recognising revenue and profit margins under IFRS 15.
2. Revenue is recognised when this is transferred.
4. If this component is significant, an adjustment shall be made to the transaction price.
5. The accounting for the transition, regardless of whether the full or the modified method is applied.
7. To recognise revenue on a percentage of completion basis, the entity must demonstrate that control is transferred to the customer in this way.
8. According to ESMA's recommendations, such data on the impact of the transition to IFRS 15 should be disclosed on a progressive basis in forthcoming financial statements, together with qualitative information.
9. Variable consideration shall be included in revenue initially recognised only to the extent that it is highly ________.
11. Only such promised goods or services may be accounted for as separate performance obligations.
12. Must be identified in the first step of the IFRS 15 revenue recognition model.

Across:

1. Entity which controls goods or services before they are transferred to the customer.
3. An entity's unconditional right to receive consideration under a contract with a customer.
5. IFRS 15 sets out the accounting treatment for its recognition.
6. The number of steps in the general revenue recognition model under IFRS 15.
7. A provision must be made for contracts of this type under IAS 37.
10. IFRS 15 only covers contracts with such parties.
13. Under IFRS 15, its recognition patterns will change as smoothing is no longer an option.
14. Method of determining percentage of completion that will no longer be permitted under IFRS 15 (except in certain specific situations).
15. Nature of the rights and obligations required for a contract to exist under IFRS 15.
16. These were published in April 2016 and clarify various principles of IFRS 15.
17. IFRS 15 defines the concept of 'contracts with customers' and requires disclosures on them to be presented there.

A Closer Look

Interactions between IFRS 9 and forthcoming *Insurance Contracts* standard: IASB publishes definitive optional approaches

On 12 September 2016, the IASB published the final version of the amendments to IFRS 4 - *Insurance Contracts.* These amendments permit insurance companies to either defer first-time adoption of IFRS 9, or to limit its effects. They thus address issues raised by having to apply IFRS 9 before the new IFRS 4.

This issue has caused a lot of concern in Europe and has been discussed by all the organisations and authorities involved with the EU endorsement of IFRS 9: EFRAG, the Accounting Regulatory Committee (ARC), the European Parliament, and so on.

The amendments confirm the two main transition options proposed in the 2015 exposure draft (see Beyond the GAAP no. 92, September 2015, and no. 95, December 2015). However, some changes have been made in response to comments received from stakeholders (see previous issues of Beyond the GAAP: no. 98, March 2016; no. 99, April 2016; and no. 100, May 2016). The two options are as follows:

- Temporary exemption (the deferral approach)
- The overlay approach.

Only one of these options may be applied at a time. Moreover, they are only available to entities that have not yet adopted IFRS 9 (with the exception of the 'own credit' requirements, which do not preclude use of the options). In contrast to the proposals set out in the exposure draft, first-time adopters of IFRS may also apply these options.

As these two approaches are optional, an entity may elect to cease applying them at any time, and must then irrevocably apply IFRS 9.

Temporary exemption

This approach involves deferring the application of IFRS 9 until the effective date of IFRS 4 Phase 2, or until the start of financial periods commencing in 2021, if the future *Insurance Contracts* standard has not yet come into force. Entities that apply this exemption will therefore continue to apply IAS 39 to all of their financial assets.

This option is only available to entities whose activities are predominantly connected with insurance. In other words, an entity must meet the following two criteria:

- the carrying amount of its liabilities arising from insurance contracts within the scope of IFRS 4 is significant (no further clarification of this term is given) in relation to the total carrying amount of all its liabilities; and
- the percentage of its liabilities connected with insurance is more than 90% of all its liabilities, or, if it is between 80% and 90%, the entity does not have any significant activities that are unconnected with insurance.

Liabilities connected with insurance comprise, among other things, investment contracts measured at fair value through profit or loss and liabilities arising from the issuance of contracts, including liabilities arising from obligations created by the contract (related tax and social liabilities). These criteria shall be assessed with regard to the financial period that immediately precedes 1 April 2016.

An entity shall re-assess whether its activities are still predominantly connected with insurance if, and only if, the structure of the entity changes significantly (which the IASB expects will be an infrequent occurrence). If such a re-assessment is carried out, an entity which did not meet the criteria at the previously-mentioned assessment date may become eligible before its first-time adoption of IFRS 9, and would thus be permitted to apply the option. On the other hand, a re-assessment could show that an entity no longer meets the criteria and is thus no longer eligible to apply the approach. It would therefore have to apply either IFRS 9 or the overlay approach (see below).

The assessment of whether or not an entity meets the criteria is carried out at the level of the IFRS reporting entity. Let us take the example of a group of companies comprising a parent company, a banking subsidiary and an insurance subsidiary (both consolidated using the full consolidation method), each of which publishes IFRS financial statements:

- the parent company assesses whether or not the group meets the criteria, in order to determine which approach (IFRS 9 or the deferral approach) will be used as the accounting policy for the consolidated financial statements;

- the banking subsidiary applies IFRS 9 to its individual financial statements, and the approach used by the parent company for its reporting packages;
- the insurance company may employ the deferral approach for its individual financial statements, provided that it meets the criteria, but must apply the approach used by the parent company for its reporting packages.

Thus, bancassurance groups may not use this approach if they have significant banking activities, unless the European authorities decide to make special provisions at the European level. Discussions on this point are ongoing.

The document includes an exemption from the requirement for entities to apply uniform accounting policies, when using the equity method. In practice, if an equity-accounted entity meets the criteria and applies the deferral approach, a parent company applying IFRS 9 does not need to restate the accounts of the equity-accounted entity. The inverse situation is also permitted. The difference in accounting policy between the equity-accounted entities and the subsidiaries is permissible in this case, as the impact is less significant for equity-accounted entities. Moreover, it is more difficult to apply uniform accounting policies when equity accounting is applied.

The use of the temporary exemption makes it difficult to compare entities with those that apply IFRS 9 or the overlay approach. As a result, substantial qualitative and quantitative disclosures in the notes are required in order to help users to make such comparisons. Consequently, entities that elect to apply the temporary exemption will have to to implement some of the provisions of IFRS 9 (notably the SPPI test, used to assess contractual characteristics) but not others (such as the calculation of expected losses).

The overlay approach

This approach is more flexible than the deferral approach in that it does not have any criteria relating to insurance activities attached to it.

It is only applicable to financial instruments that are not currently measured at fair value through profit or loss (FVPL) in their entirety under IAS 39 but that must be measured at FVPL under IFRS 9 (notably assets held for sale, assets that are bifurcated under IAS 39 that would be measured at FVPL under IFRS 9, and loans and receiveables held to maturity that do not pass the SPPI test). Financial assets are only eligible for this approach if they are designated as backing insurance contracts. An entity may choose whether to apply this approach to all or some of the eligible assets.

The overlay approach does not change the accounting treatment of financial instruments in the statement of financial position, or line items in the statement of profit or loss relating to changes in the balance sheet amounts. However, an entry should be added to the statement of profit or loss to reclassify to OCI the impact of the difference between the current accounting under IAS 39 and the new accounting under IFRS 9. This entry should be presented as a line item in the statement of profit or loss, and separately in OCI. Thus, total comprehensive income will not be affected by this entry.

If this approach is used, the entity shall disclose this in the notes, together with additional qualitative and quantitative information. As comparison with entities applying IFRS 9 is much easier, the disclosure requirements are much less detailed than for temporary exemption.

Any change in the designation of assets for the overlay approach, or de-designation of assets, must reflect a change or cessation of the relationship between the asset and liability in question. The difference is then recycled to profit or loss. Once an entity ceases to use the overlay approach, it may not subsequently (re)apply it.

The document states that the use of shadow accounting may be applicable when the overlay approach is used.

This approach should permit insurers to present a statement of profit or loss under IFRS 9 that is relatively close to that presented under IAS 39. However, in practice it requires the entity to be able to monitor both accounting approaches at the same time, in order to calculate the amount to be reclassified.

These amendments must now undergo the European endorsement process, together with IFRS 9 which is now in the final phase.

Key points to remember

These amendments go some way to addressing the mismatch that could arise from applying IFRS 9 before the new Insurance Contracts *standard. Each of the options has pros and cons to consider, in terms of both accounting impacts and implications for reporting systems.*

The temporary exemption (the deferral approach) may only be used until a certain date and if the entities meet certain criteria stipulating that their activities must be predominantly connected with insurance. If an entity applies this exemption it need not apply IFRS 9, but more detailed disclosures are required in the notes compared with the overlay approach. The overlay approach, on the other hand, is available to all entities with insurance liabilities. However, an entity which uses this approach will need to keep track of the accounting under both IFRS 9 and IAS 39, until such time as the new Insurance Contracts *standard is applied.*

Events and FAQ

Frequently asked questions

IFRS

- Allocation of free graded vesting shares: accounting treatment on transition to IFRS.
- Business combination versus acquisition of assets.
- Successive business combinations as part of a single acquisition contract.
- Sale of a building permit with a commitment to lease back the building once constructed.
- Presentation of a liability relating to contingent consideration in financial liabilities or operating liabilities.

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

IFRS		EFRAG	
IASB	**Committee**	**Board**	**TEG**
17-21 October	8-9 November	10 November	26-27 October
14-18 November		13 December	23-25 November
12-16 December		12 January	19-20 December