

Beyond the GAAP

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For some months, the Leases project seemed to have reached deadlock, largely due to the difficulties encountered by the two Boards in deciding how to account for the result. Some observers were wondering whether it would ever see the light of day.

Regardless of whether they will be pleased or upset, the two Boards have not thrown in the towel. They have just reached agreement on the profit or loss pattern in lessee accounting, and confirm that a new exposure draft will be published in 2012 (Q4), but remain guarded on the publication date for the final standard.

This prudence is necessary given what is at stake, especially in view of the number of topics still to be addressed in the revenue recognition project in the light of the comments letters received.

Enjoy your reading!

Michel Barbet-Massin

Edouard Fossat

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Editors in chief:

Michel Barbet-Massin, Edouard Fossat

Columnists:

Claire Dusser, Carole Masson, Egle Mockaityte, Didier Rimbaud and Arnaud Verchère.

Contact us:

Mazars

Laurence Warpelin

Laurence.warpelin@mazars.ch

Tél. : +41 21 310 49 03

Denise Wipf

denise.wipf@mazars.ch

Tél. : +41 44 384 93 75

www.mazars.ch

News

Speech by Michel Prada

In a speech delivered on 27 June 2012 at the IFRS Foundation conference, Michel Prada, Chairman of the IFRS Foundation Trustees, set out his vision of the principal challenges for the Foundation, in order to improve the drafting, acceptance and adoption of IFRSs as follows:

- Increasing collaboration with national standard-setters;
- Putting more emphasis on the implementation of IFRS, to ensure that they are approved and applied in a more consistent fashion throughout the world;
- Enhancing confidence in the standard-setting process and the robustness of the Standards by enhancing the IASB's due process.

Mr Prada's speech can be consulted in full on the IASB site at

<http://www.ifrs.org/Alerts/Conference/MP+Frankfurt+speech+June+2012.htm>

Publication of the IFRS Foundation 2011 annual report

On 12 June 2012, the IFRS Foundation published its 2011 annual report. This report is available on the IASB site at

<http://www.ifrs.org/Alerts/PressRelease/2011+Annual+Report.htm>

➤ The IASB updates its work plan

In June the IASB twice updated its work plan. The main changes are as follows:

- *IFRS 9 Classification and measurement*: the exposure draft amending IFRS 9 provisions on classification and measurement, previously expected during the second half of the year, is likely to be published during Q4 2012;
- *IFRS 9 Macro hedge accounting*: the IASB has decided on the form to be taken by the forthcoming document on macro hedging. A discussion paper will therefore be published during the second half of 2012;
- *Leases*: the new exposure draft on lease accounting, previously expected during the second half of the year, should be published during Q4 2012;
- *Annual improvements 2010-12*: completion of the 2010-2012 omnibus (see the study below) is expected in Q1 2013;
- *Consolidation - Investment entities*: the final standard on the consolidation exemption for certain companies is expected in the second half of 2012;
- *IAS 8 Effective date and transition methods*: in the previous edition, we reported that the IASB had taken the decision to publish a limited exposure draft on IAS 8 during the second half of 2012 (see Beyond the GAAP N°56, May 2012). This project has now been included in the IASB work plan.

Finally, the IFRS for SMEs Comprehensive Review 2012-2014 has also been placed on the IASB work plan (see below).

➤ Consolidation exemption for investment entities

During the June 2012 meetings, the two Boards continued their discussions of the final strand in the revision of the standards on Consolidation, the *Investment entities* project.

During this meeting, the two Boards reached a decision on the consolidation exemption:

- for investment entities; and
- for subsidiaries controlled by a non-investment entity parent through an investment entity.

In the first case, the two Boards have tentatively decided that investment entities should be required to measure all controlling financial interests in another entity at fair value, rather than consolidating those subsidiaries.

If the two Boards have agreed on the principle of consolidation exemption for investment entities, they are not entirely as one on the disclosures required:

- The IASB tentatively decided not to require an investment entity to attach the financial statements of its investees, whereas
- The FASB tentatively decided to require a feeder fund in a master-feeder structure to attach its master fund's financial statements along with its financial statements.

In the second case of subsidiaries controlled by a non-investment entity parent through an investment entity, the differences are even more marked, since:

- The IASB tentatively decided that a non-investment entity parent should not retain the exception from consolidation, whereas
- The FASB tentatively decided to retain the requirement in current US GAAP that a non-investment company parent should retain the specialised accounting used by an investment company subsidiary, i.e. the fair value accounting of investments in the parent's accounts.

➤ IFRS for SMEs: the IASB launches a comprehensive review

During the June 2012 meeting, the IASB approved the launch of a comprehensive review of IFRS for SMEs over the period 2012-2014.

Consequently, on 26 June 2012 the IASB published a Request for Information prepared in collaboration with the SMEIG, in order to:

- seek public views on whether there is a need to make any amendments to the IFRS for SMEs, and
- identify what amendments should be made.

The deadline for responses is 30 November 2012.

The comprehensive review will entail:

- the publication of an exposure draft, prepared on the basis of the comments received, during the second half of 2013;

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- the publication of the final amendments during the second half of 2013 or the first half of 2014.

The IASB has announced that the resulting amendments to IFRS for SMEs will be effective in 2015.

➤ **Transition to IFRS 10, IFRS 11 and IFRS 12: IASB publishes the final amendments**

Last May 2012 we reported that the IASB:

- had issued rules on transitional arrangements for IFRS 10, and
- had proposed some further simplifications of the disclosures on interests in other entities for the transition to IFRS 10, IFRS 11 and IFRS 12.

On 28 June 2012, the IASB published the final amendments to the transitional arrangements for IFRS 10, IFRS 11 and IFRS 12 including all the amendments discussed in May (for more details on these amendment, see Beyond the GAAP N°56, May 2012, pp. 2-3).

It therefore only took a month for the transitional arrangements which the two Boards had decided or simply envisaged to appear in their final concrete form in the standards.

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Annual Improvements to IFRSs – 2010-2012 Cycle

On 3 May 2012, the IASB published the exposure draft Annual Improvements to IFRSs Cycle 2010-2012. The deadline for the public comments is 5 September 2012. Beyond the GAAP here presents the IASB's proposed amendments, standard by standard.

➤ IFRS 2 Share-based Payment

As it stands, IFRS 2 *Share-based Payment* provides no definitions of 'performance conditions' or 'service conditions', but describes these concepts in the definition of vesting conditions.

The amendment proposed by the IASB aims to clarify the definition of 'vesting conditions' by indicating that a vesting condition is either a 'performance condition' or a 'service condition', and offering an exact definition of each of these concepts. Thus, the new definitions will be inserted in Annex A of the standard, in the following terms:

- **Performance condition:** A vesting condition that requires:
 - (a) the counterparty to complete a specified period of service; and
 - (b) specified performance targets to be met while the counterparty is rendering the service required in (a).A performance target is defined by reference to the entity's own operations (or activities) or the price (or value) of its equity instruments (including shares and share options). A performance target might relate either to the performance of the entity as a whole or to some part of the entity, such as a division or an individual employee.
- **Service condition:** A vesting condition that requires the counterparty to complete a specified period of service. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, the counterparty has failed to satisfy the condition.

These amendments also provide answers, set out in the Basis for Conclusions, to a number of questions posed by preparers on the concept of a vesting condition:

- **Is there a correlation between an employee's responsibility and the performance target?** The Board observed that it is reasonable to assume that the performance target set by management appropriately incentivises the employee to provide an increased quality and/or quantity of service to benefit the entity.
- **Can a share market index target constitute a performance condition or a non-vesting condition?** The Board observed that a share market index target is not influenced by the employee, since it may be affected by many factors, including macroeconomic factors, even if the entity's shares form part of the index. Consequently, the Board believes that a share market index target constitutes a non-vesting condition.
- **Can a performance target that refers to a longer period than the required service period constitute a performance condition?** The Board proposes to make clear that in order to constitute a performance condition, any performance target needs to have an explicit or implicit service requirement for at least the period during which the performance target is being measured.
- **Is the employee's failure to complete a required service period considered to be a failure to satisfy a service condition?** The definition of a service condition in the exposure draft clearly states that an employee fails to satisfy a service condition if that employee fails to satisfy the specified service period, regardless of what the reason for that failure is. The compensation expense previously recognised (before the point of failure) would need to be reversed.

The IASB proposes that this amendment be of mandatory application to current financial periods at 1 January 2014. Early application is permitted.

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➤ IFRS 3 Business Combinations

The amendment clarifies that contingent consideration meeting the definition of a financial instrument must be assessed either as a liability or an equity instrument on the basis of the requirements of IAS 32. Thus, all references to other standards would be deleted.

The amendment also clarifies that the contingent consideration classified in financial liabilities must subsequently be measured at fair value, with the corresponding gain or loss being recognised either in profit or loss or other comprehensive income in accordance with IFRS 9.

IFRS 9 would be also amended to clarify that contingent consideration that is a financial asset or liability can only be measured at fair value (i.e. no amortised cost measurement would be possible for contingent consideration).

The IASB proposes that this amendment be prospectively applicable to current financial periods at 1 January 2015. Early application is permitted.

➤ IFRS 8 Operating Segments

The proposed amendments to IFRS 8 *Operating Segments* relate to two areas:

- the aggregation of operating segments;
- the reconciliation of the total of the reportable segments' assets to the entity's assets.

Aggregation of operating segments

In application of IFRS 8 (paragraph 12), it is currently possible to aggregate several operating segments in a single segment if the segments have similar economic characteristics, and the segments are similar in each of the following respects:

- (a) the nature of the products and services;
- (b) the nature of the production processes;
- (c) the type or class of customer for their products and services;
- (d) the methods used to distribute their products or provide their services; and
- (e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

An entity is only required to provide general disclosures on the factors used to identify the segments presented. There is no requirement for any particular disclosures when operating segments have been aggregated.

The proposed amendment therefore aims to improve disclosure on aggregated operating segments by asking for information on the judgements made by management in applying the aggregation criteria in paragraph 12.

In particular, an entity must provide a brief description of the operating segments that have been aggregated and the economic indicators that have been assessed in determining that they share similar economic characteristics.

Reconciliation of the total of the reportable segments' assets to the entity's assets.

Here the proposed amendment aims to clarify the disclosures required in the light of the April 2009 amendment to IFRS 8, which states that a measure of total assets for each reportable segment needs to be disclosed only if that amount is regularly provided to the chief operating decision maker (paragraph 23).

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The proposal therefore indicates that the reconciliation of the total of reportable segments' assets to the entity's assets must only be provided if the segment assets are themselves presented in application of the section 23 of the standard.

This clarification is in line with the requirements for disclosures on segment liabilities.

The IASB proposes that these amendments be of mandatory application to current financial periods at 1 January 2014. Early application is permitted.

➤ IFRS 13 – Fair Value Measurement

The proposed amendment consists solely of an amendment to the Basis for Conclusions of IFRS 13 in order to explain the Board's rationale for removing paragraph B5.4.12 of IFRS 9 *Financial Instruments* and paragraph AG79 of IAS 39 *Financial Instruments: Recognition and measurement*.

The Board proposes to clarify that, when making those amendments to IFRS 9 and IAS 39, it did not intend to remove the option to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial.

Instead, the Board deleted those paragraphs because IFRS 13 contains guidance for using present value techniques to measure fair value and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* addresses materiality in applying accounting policies. The combination of these two standards should have the effect of retaining the existing practice of not discounting short-term receivables with no stated interest rate.

This amendment will not be endorsed by the European Commission, since the adoption process only applies to the standard and not to the Basis for Conclusions.

➤ IAS 1 Presentation of Financial Statements

Paragraph 73 of IAS 1 states that a liability maturing in less than one year is classified as non-current if an entity expects, and has the discretion, to refinance or roll over the obligation for at least twelve months after the reporting period under an existing loan facility.

The proposed amendment clarifies that the loan facility must be with the same lender, under the same or similar terms, i.e. with no significant changes in the rights and obligations of the parties to the loan facility.

The IASB proposes that this amendment be prospectively applicable to current financial periods at 1 January 2014. Early application is permitted.

➤ IAS 7 Statement of Cash Flows

The IASB received a request to clarify the presentation in the statement of cash flows of interest paid that it capitalised in the cost of property, plant and equipment, because there is a contradiction within IAS 7:

- paragraph 16 seem to suggest that cash flows corresponding to capitalised interest must be presented as part of an entity's investing activities,
- whereas paragraphs 32 and 33 indicate that interest paid should be presented either in operating cash flows or in financing cash flows.

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To resolve this conflict, the IASB proposes to clarify that capitalised borrowings costs should follow the classification of the underlying asset. In practice, payments of interest that is capitalised in the cost of a tangible or intangible asset should be presented in cash flows from investment activities.

This modification also covers the classification of payments of interest that have been capitalised as part of operating assets (such as inventory). These cash flows would therefore be classified as part of an entity's cash flows from operating activities.

The IASB proposes that this amendment be of mandatory application to current financial periods at 1 January 2014. Early application is permitted.

➤ IAS 12 Income Taxes

The origin of this amendment lies in a question to the IFRS Interpretations Committee on how an entity should determine whether to recognise a deferred tax asset under IAS 12 where this entity:

- has a deductible temporary difference relating to an unrealised loss on a financial liability classified as available for sale (AFS),
- has the ability and intention to hold the instruments until the loss reverses (which may be at their maturity), and
- has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise that temporary difference.

To answer this question, the IASB proposes to amend IAS 12 to clarify that:

- (a) If tax law restricts the sources of tax losses so that an entity can only deduct the tax losses against income of a specified type (e.g. if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset corresponding to a deductible temporary difference in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type;
- (b) taxable profit against which an entity assesses a deferred tax asset for recognition is the amount before any reversal of deductible temporary differences;
- (c) an action that results only in the reversal of existing deductible temporary differences is not a tax planning opportunity. To qualify as a tax planning opportunity, the action needs to create or increase taxable profit.

The proposed amendment reflects the tentative conclusions that the Board reached when it analysed deferred tax assets arising from unrealised losses on available-for-sale debt instruments. However, the proposed amendment is not limited in scope to those deferred tax assets, but may also be relevant for deferred tax assets resulting from other transactions and events.

The IASB proposes that this amendment be applicable to current financial periods at 1 January 2014. Early application is permitted.

➤ IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets

The IASB proposes the following amendments to IAS 16 and IAS 38 relative to assets accounted for according to the revaluation method. When an item of property, plant and equipment or an intangible asset is revalued, the revaluation could be treated in one of the following ways:

- the gross carrying amount is restated in a manner consistent with the revaluation of the net carrying amount (for example, the gross carrying amount may be revalued by reference to market data, or it may be restated proportionately to the change in the net carrying amount). In this instance, the accumulated depreciation is the difference between the gross and net carrying amounts; or

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- the accumulated depreciation is eliminated, the revalued amount of the asset becoming the new gross carrying amount.

This second method (elimination of accumulated depreciation) can already be found in the existing IAS 16 and IAS 38 standards. However, the first method represents a change from the existing provisions, which require a proportionate revaluation of both the gross carrying amount and the accumulated depreciation.

The IASB proposes that this amendment be applicable to current financial periods at 1 January 2014. Early application is permitted.

➤ IAS 24 Related Party Disclosures

The IASB had received a request for clarification of the disclosures required where the reporting entity receives key management personnel services from a management entity which is not otherwise a related party of the entity. Should the reporting entity disclose the amounts paid by the management entity to the key management personnel?

The IASB identified some divergences of practice, some entities disclosing the costs paid to the management entity, others indicating the remuneration paid by the management entity to the key management personnel.

The proposed changes to IAS 24 are as follows:

- the definition of a related party is extended to include a management entity providing key management personnel services to the reporting entity;
- the reporting entity must disclose the amounts paid to the management entity for the provision of key management personnel services. The compensation that is provided by a management entity to key management personnel is excluded from the disclosure requirements;
- the other transactions between the reporting entity and the management entity should also be presented as related party transactions (for example, if a loan is granted to the management entity).

The IASB proposes that this amendment be applicable to current financial periods at 1 January 2014. Early application is permitted.

➤ IAS 36 Impairment of Assets

An amendment published in 2008 (*Annual improvements to IFRS, May 2008*) addressed an inconsistency in the disclosure requirements for circumstances in which the recoverable value of a cash-generating unit (CGU) was measured on the basis of its value in use or of fair value less costs of disposal, when this last was based on a discounted cash flow basis.

Thus, when fair value less costs of disposal is determined using discounted cash flows, the same disclosures are required as for value in use (the period over which the cash flows have been projected, the growth rate used to extrapolate the projections and the discount rates applied).

The amendment which is now proposed is consistent with the May 2008 amendment. The IASB proposes that the IAS 36 requirements for disclosures on value in use where a material impairment has been recognised or reversed during the period also apply when the recoverable value corresponds to fair value less costs to sell estimated using discounted cash flows.

The IASB proposes that this amendment be applicable prospectively to current financial periods at 1 January 2014. Early application is permitted.

Levies charged by public authorities on entities that operate in a specific market – Draft interpretation from the IFRS Interpretations Committee

On 31 May 2012, the IFRS Interpretations Committee (formerly IFRIC) published draft interpretation DI/2012/1 on levies charged by public authorities on entities that operate in a specific market. The closing date for comments on this project is 5 September 2012.

➤ What is the scope of this draft interpretation?

This draft interpretation concerns levies:

- within the scope of IAS 37 *Provisions* (excluding taxes within the scope of IAS 12 *Income taxes*);
- which are due from entities operating in a specific market (such as a specific country, a specific region or a specific market in a specific country);
- where the entity paying the levy does not receive any specific asset in direct exchange for the payment of the levy (this excludes contracts between a public authority and the entity);
- where the payment is in accordance with a law or regulation;
- which are triggered when a specific activity identified by the legislation occurs, which may be at a specific date or occurring over a given period;
- the amount of which is calculated using data for the current period or a previous reporting period, such as the gross amount of revenues, assets or liabilities.

In practice, very many entities are affected.

Should this project be brought to a successful conclusion, it will be necessary to review the accounting treatment of other taxes, such as the contribution to the costs of the Prudential Supervisory Authority (for the banking and insurance sector).

➤ What has not been addressed by the draft?

This draft interpretation does not address levies which are due only if a revenue threshold is achieved, as the Committee failed to reach agreement.

There was no consensus as to whether:

- achieving the threshold is an obligating event after which the levy is due, and the liability should be recognised at a point in time only after the threshold is met (that is, the existence of the threshold directly affects the recognition of the liability); or

Under this approach, no present obligation exists until the threshold is achieved. Further, several examples in IAS 37 indicate that expenses benefiting an entity's future activity or related to future decisions do not constitute liabilities.

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- the levy should be provisioned once it is probable that the threshold will be achieved (that is, the threshold only affects the measurement of the liability).

This approach may be supported by analogy with an example drawn from IAS 34 relating to lease payments. This standard suggests that where lease payments are contingent on the achievement of a certain level of annual sales, a liability should be recognised when it is expected that the threshold will be reached.

➤ What does the draft interpretation say?

The obligating event that gives rise to the recognition of a levy is the activity that triggers the payment of the levy as identified by the legislation.

For example, if the activity that triggers the payment of the levy is the generation of revenues in the current period but the amount of that levy is based on revenues generated in a previous period, the obligating event for that levy is the generation of revenues in the current period.

An entity has no constructive obligation to pay a levy that will arise from operating in a future period as a result of being economically compelled to continue operating in that future period.

The preparation of financial statements under the going concern principle does not imply that an entity has an implicit obligation to continue its operations, and therefore does not lead to the entity recognising a liability for levies that will arise from its future activity.

The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (i.e. if the activity that triggers the payment of the levy occurs over a period of time).

For example, a liability is recognised progressively if the obligating event is the progressive generation of revenues over the current period.

The same recognition principles should be applied in the interim financial statements as in the annual financial statements. As a result, the levy expense should not be:

- anticipated if there is no present obligation to pay the levy at the end of the interim reporting period; or
- deferred if a present obligation to pay the levy exists at the end of the interim period.

➤ Practical illustrations (drawn from the draft interpretation)

The draft offers three examples, summarised below, which illustrate the accounting for an entity with a reporting period ending in December.

Levy linked to revenue generated in the current period

The levy results from the generation of revenue by the entity over the current period. In this instance, the liability is recognised progressively over the period because the obligating event is the generation of revenue over the period.

At any point, the entity has a present obligation to pay a levy on revenues generated to date. However, the entity has no present obligation to pay a levy on revenues not yet generated.

In the interim financial statement, for example at 30 June, the entity has an obligation to pay the levy on revenues generated during the first half of the year.

Levy triggered in full as soon as the entity generates revenues in a specific market

A levy is triggered in full as soon as the entity generates revenues in reporting period N. The amount of the levy is determined by reference to revenues generated by the entity during the period N-1.

The entity begins to generate revenues on 3 January N.

In this example, the liability is recognised in full on 3 January N because the obligating event, as identified by the legislation, is the first generation of revenues in N.

The generation of revenues in N-1 is necessary, but not sufficient, to create a present obligation to pay a levy. Before 3 January N, the entity has no obligation. In other words, it is the revenue generated in N which is the activity triggering the payment of the levy. The generation of revenues in N-1 is not the activity that triggers the payment of the levy (the revenue in N-1 only affects the measurement of the liability).

In the interim financial report, the expense is recognised in full in the first interim accounts. The expense may neither be deferred until subsequent interim periods nor anticipated in previous interim periods.

Levy triggered if the entity operates as a bank at the end of the annual reporting period in a specific market

A levy is triggered only if the entity operates as a bank at the end of the annual reporting period in a specific market. The amount of the levy is determined by reference to amounts in the balance sheet at the end of the reporting period.

The liability is recognised at the end of the reporting period because the obligating event, as identified by the legislation, is to operate as a bank at the end of the annual reporting period.

Before the end of this period, the entity has no present obligation, even if it is economically compelled to continue to operate in the future and to operate as a bank at the end of the annual reporting period.

The activity that triggers the payment of the levy as identified by the legislation is to operate as a bank at the end of the annual reporting period - an event which cannot occur before the end of the period in question.

Even if the amount of the liability is based on the length of the reporting period, the obligating event is to operate as a bank at the end of the annual reporting period, so the liability is not recognised progressively.

Because the liability is recognised in full at the end of the reporting period, the expense is also recognised in full on the same date. The expense may neither be deferred until subsequent interim periods nor anticipated in the interim statements.

➤ What would be the effective date of this interpretation?

At this stage, no effective date has been identified.

However, application should be retrospective (as with any change in accounting policies). Early application will be permitted.

In view of the significant impact this will have on existing practice, not least in France due to the accounting treatment generally applied to the social solidarity contribution, the Committee may well receive a large number of comments letters (reminder: the closing date is 5 September 2012).

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Puts options written on non-controlling interests – Draft interpretation from the IFRS Interpretations Committee

On 31 May 2012, the IFRS Interpretations Committee (formerly IFRIC) published draft interpretation DI/2012/2 on accounting for changes in the liability recognised for Put Options Written on Non-controlling Interests ("NCI puts"). The closing date for comments on this draft is 1 October 2012.

➤ For puts within the scope of the interpretation, changes in liability must in future be recognised in profit or loss.

Historically, several approaches have been applied to subsequent changes in liability (for more details, see Beyond the GAAP N° 52, January 2012). The draft interpretation which has just been published proposes to account for changes in the liability recognised for the put in profit or loss.

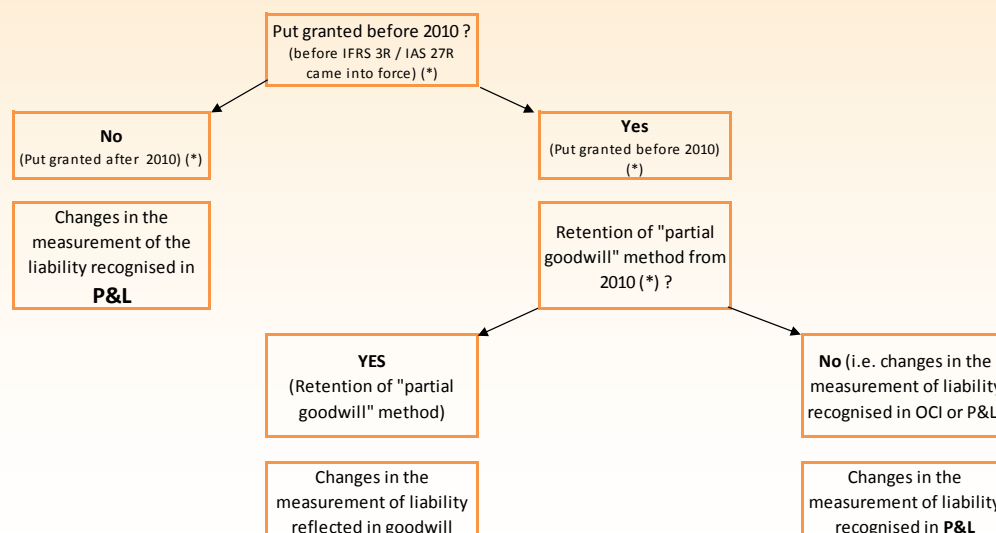
The Committee considers that paragraph 30 of IAS 27, relating to variations in the percentage of interest held in a subsidiary, is not applicable to puts on non-controlling interests as the relative interest is not changed before any exercise of the put by the non-controlling shareholder.

The put requires the recognition of a debt vis-à-vis the non-controlling interest, and the variations in the debt have no impact on the respective ownership interests of the group and the non-controlling shareholders.

➤ What is the scope of this draft interpretation?

The draft Interpretation would not apply to NCI puts that were accounted for as contingent consideration in accordance with IFRS 3 Business Combinations (2004).

In practice, this means that puts accounted for using the "partial goodwill" method will not be affected by this interpretation, and will be able to continue to use this accounting approach.



(*) For entities whose reporting period coincides with the calendar year and which have not decided to apply IFRS 3R / IAS 27R early

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➤ What should we make of the draft interpretation?

In technical terms, the Committee's analysis is understandable insofar as it is true that changes in a financial liability normally impact profit or loss.

In terms of financial communication, our judgement is more severe:

- The accounting treatment proposed implicitly assumes that this is a normal liability, whereas the particular nature of puts on non-controlling interests means that they straddle IAS 32 and IAS 27.

This approach is automatic (all changes in a financial liability must be accounted for in profit or loss).

The fact that it is specific provisions in IAS 32 which require the recognition of a liability makes it all the more appropriate to query the validity of the approach in this particular case.

- The end result of this accounting treatment is often counter-intuitive, especially in the many cases where the exercise price is based on the fair value of shares at the exercise date.

This approach means that increases in the liability are accounted for in expenses, although it is the sound management of the entity by the majority shareholder which is behind the increase, and the purchase price is a 'normal' price.

In other words, a purchase, at a normal price, offering a simple way out for a minority shareholder, will have an impact on the group result where the group has entered into an undertaking (i.e. has a granted a put). However, a simple purchase, at the same prices as in the previous example but without a prior undertaking, will be reflected by a simple impact on equity (i.e. with no impact on profit or loss).

- Finally, the Basis for Conclusion recall the Committee's original proposal (rejected by the IASB) to amend IAS 32 to account for puts on non-controlling interests as derivatives, i.e. on the basis of their fair value, without recognising the liability as such (for more details of this proposed amendment, see Beyond the GAAP, March and September 2011).

In other words, the members of the Committee themselves seem have reservations about the proposed accounting treatment.

➤ What are the next steps?

As noted, the comments period ends on 1 October 2012, and it is important for interested parties to make the time to explain their positions on this draft.

This draft interpretation recalls the (un)lamented IFRIC 3 interpretation on greenhouse gas quotas.

That interpretation, published in December 2004, was withdrawn by the IASB in June 2005. The Board concluded that this was a good technical interpretation, but that it could under some circumstances lead to unsatisfactory accounting consequences.

Let us hope that the Committee will take the opportunity in the forthcoming months to reconsider this sensitive subject.

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Leases: the profit or loss recognition pattern emerges!

Last February 2012, we reported the most recent reflections of the IASB and the FASB on the recognition profile of lease payments by lessees. Two fairly complex approaches were discussed: the underlying asset approach and the interest-based amortisation approach, though no tentative decisions were taken by the Boards.

During the June sessions, the two Boards returned to these discussions and reached agreement on the principles which should underpin the recognition of lease expenses in lessee accounting. The description of these principles suggests that the resulting accounting models will certainly be more straightforward to apply than those presented last February (see Beyond the GAAP N°53, February 2012).

This study will now set out the tentative decisions taken by the two Boards on the main principles for the recognition of the lease expenses by lessees.

➤ A fundamental principle: two types of leases

The Boards have finally acknowledged that there are two types of leases:

- Leases using an approach similar to that proposed in the 2010 Leases exposure draft;

Remember that in this exposure draft, the lessee would not recognise lease expenses on a straight-line basis, since it would recognise an expense for the amortisation of the right of use (generally linear) and an interest expense decreasing over the lease term (i.e. the financial expense automatically reduces as the lease liability is repaid).

- Leases using an approach that results in a straight-line lease expense.

These two different types of leases should be distinguished on the basis of whether the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term.

➤ Application of the fundamental principle

The Boards propose to apply this principle by making a further distinction between leases on investment property and on assets of another type.

- **Leases on investment property** should be accounted for using the straight-line approach, unless:
 - the lease term is for the major part of the economic life of the underlying asset; or
 - the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset.
- **Leases on assets other than investment property** should be accounted for using an approach similar to that proposed in the 2010 Leases exposure draft (i.e. expenses should not be recognised on a straight-line basis), unless:
 - the lease term is an **insignificant** portion of the economic life of the underlying asset; or
 - the present value of the fixed lease payments is **insignificant** relative to the fair value of the underlying asset.

Although "insignificant" is not clearly defined, we may already wonder whether in practice this concept will not result in the straight-line recognition of lease expenses to be applicable for a very limited number of leases.

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➔ What will be the impact on lessor accounting?

These discussions will also have repercussions on lessor accounting.

The Boards have already announced that they have revoked the tentative decisions so far taken for determining when the “receivable and residual asset” model should apply.

In order to remain consistent with the lessee accounting decisions taken, the Boards have decided that lessors too should distinguish two types of leases:

- Leases which apply the “receivable and residual asset” model (non-linear recognition profile), and
- Leases which apply a model close to the operating leases model in IAS 17 (straight-line profile).

This distinction will operate according to the same principles as those presented above for lessee accounting.

Therefore, the lessor will apply the “receivable and residual asset” model to leases for which the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term.

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Revenue Recognition: how have stakeholders responded to the IASB's new proposals?

In May 2012, as revealed in the previous edition of *Beyond the GAAP*, the IASB and the FASB received a summary of feedback from stakeholders in response to the second exposure draft on revenue recognition published in November 2011 (see *Beyond the GAAP* N°50 and N°51, November and December 2011).

This feedback was received either in the form of comments letters or during the outreach activities conducted by the IASB and the FASB.

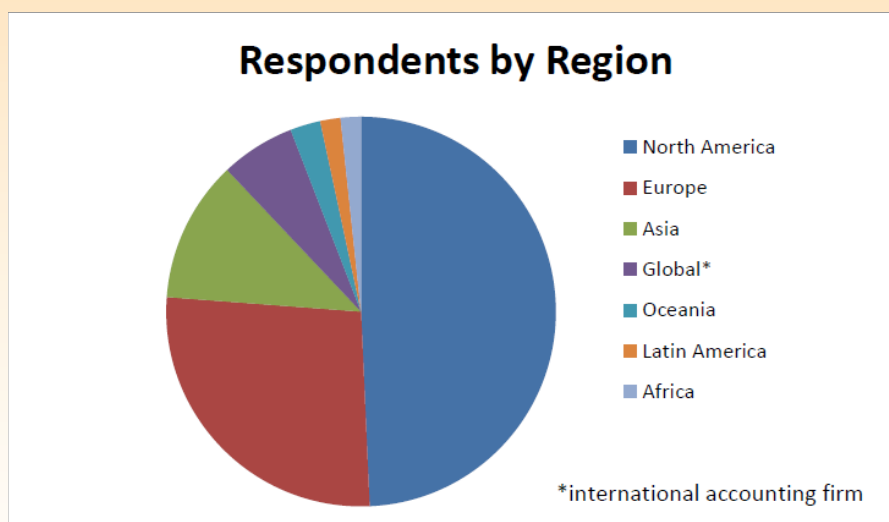
Though the criticisms were generally milder than those made in response to the first exposure draft, the two Boards will have to rework some of the key concepts in the future standard during the months to come, in order to make it workable in practice and to ensure that the final proposals make it possible to communicate effectively the economic reality of contracts concluded with customers to the users of financial statements.

➤ Where did the comment letters come from?

At the date when the staff finalised this summary, 227 comment letters had been received by the IASB and the FASB. That is far fewer than for the first exposure draft (when nearly 1,000 comment letters were received). It should be said that in the meantime the two Boards have sought to reassure the construction industry, which contributed half of the comment letters received in response to the first exposure draft.

Geographic origin of commentators

Half the comment letters received come from North American commentators, and little more than a quarter from commentators in Europe.

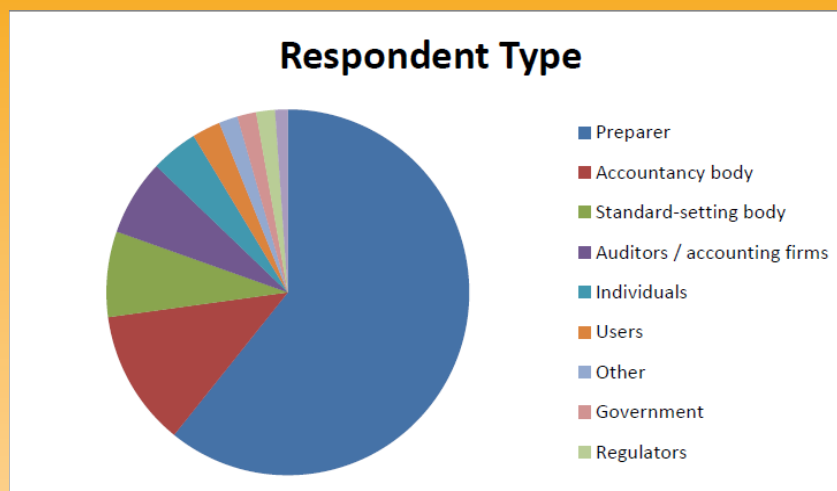


Types of commentators

Unsurprisingly, accounts preparers are most strongly represented, being responsible for around two-thirds of the comment letters. Their involvement should be welcomed all the more since the comments period (14 November 2011 to 13 March 2012) was not conducive to a massive contribution.

¹ Agenda Paper 7A available at: <http://www.ifrs.org/NR/rdonlyres/F82E890E-33FF-4C04-AA87-52F232AD26F4/0/RR0512b07A.PDF>

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➤ Summary of feedback on the main questions which may affect the framework for the recognition and measurement of revenue

Stakeholders' comment addressed the following areas:

- performance obligations which are satisfied over time;
- identification of separate performance obligations;
- constraints on the cumulative amount of revenue recognised;
- accounting for customer credit risk;
- time value of money.

Performance obligations which are satisfied over time

Most commentators have welcomed the addition, to the first exposure draft, of a list of criteria for use in assessing the transfer of control of a good or service to the client over time. Remember that according to paragraph 35 of the draft standard:

An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognises revenue over time if at least one of the following two criteria is met:

(a) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. An entity shall apply the requirements on control in paragraphs 31–33 and paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or

(b) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and at least one of the following criteria is met:

(i) the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

(ii) another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. In evaluating this criterion, the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset (for example, work in progress) presently controlled by the entity. In addition, an entity shall disregard potential limitations (contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity.

(iii) the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised. The right to payment for performance completed to date does not need to be for a fixed amount. However, the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

²Under § 36, an entity shall consider at contract inception the effects of contractual and practical limitations on the entity's ability to readily direct the

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promised asset to another customer.

Most commentators remarked that these criteria were complex and difficult to apply in some practical situations. For reasons of simplicity, some commentators asked that contracts which are fulfilled over a period of less than 12 months should be accounted for as contracts satisfied at a point in time (i.e. without recognising revenue over time).

In more detail, the following comments were made:

- the linkage between the concept of the transfer of control to the customer and the paragraph 35 criteria should be more clearly expressed. This relates in particular to the notions of 'alternative use', 'another entity would not have to re-perform', and 'right to payment for performance completed to date';
- the definition and application of the notion of 'alternative use' should be reworked to ensure that it is understood by everyone in the same way;
- several commentators mentioned that the criterion in paragraph 35(b)(ii) apparently duplicated the criterion in paragraph 35(b)(i) in respect of e.g. a transportation service. Other commentators wondered in particular how this criterion could be applied to construction contracts, which was not made clear in the exposure draft and the basis for conclusions;
- many commentators raised queries on the 'right to payment', including:
 - whether a 'right to payment' would be considered as acquired when milestones were achieved or stage payments would be required to be made;
 - whether the contract terms only need be taken into account or whether they should also consider general business practices and/or the legal environment in which the contract was signed;
 - what amount would be considered as satisfying the 'right to payment' if the customer terminates the contract before completion. As the criterion in paragraph 35(b)(iii) is in many cases the only criterion which can be shown to be satisfied, the clarifications expected in the final standard will be of crucial importance.

Identification of separate performance obligations

Although this subject was not the subject of a specific question in the second exposure draft, several commentators noted that the new proposals marked a considerable improvement on the first exposure draft.

This relates to in particular paragraph 28 of the exposure draft, on the notion of a separate goods or services, and paragraph 29, on the fact that a bundle of goods and services only represents a single performance obligation under certain conditions.

However, in practice the identification of separate performance obligations raises many questions:

- was paragraph 29 drafted so that it would only apply to construction contracts? Does it apply to services sold in the form of packages by the software industry?
- how should the fundamental terms of paragraph 29 be understood, the requirement that goods or services must be 'highly interrelated', representing 'a significant service of integration' or 'customisation'? These terms need clarification to ensure the consistent application of the standard. For example, what level of customisation of the goods and services provided to the customer to meet the contract conditions should be observed if paragraph 29 is applicable?
- should contracts that provide repetitive services delivered consecutively (e.g. a year's maintenance tacitly renewed) or for the production of similar specialised items (e.g. the construction of 50 specialised aircraft for a single customer) be considered to represent a single performance obligation, fulfilling the conditions of paragraph 29?
- what is the scope of the practical expedient in paragraph 30 of the exposure draft, in accordance with which an entity may account for several goods or services as a single performance obligation if they have the same pattern of transfer? In particular, should the application of the expedient systematically result in the same

accounting treatment as if the entity had not applied the expedient?

Constraining the cumulative amount of revenue recognised

The principle set out in paragraph 81 of the exposure draft is the following: if the consideration to which the entity is entitled is variable, the cumulative amount of revenue that the entity recognises to date shall not exceed the amount that the entity is reasonably assured to be entitled to. An entity is reasonably assured to be entitled to the consideration for satisfied performance obligations only if it has experience of this type of performance obligations and is able to predict the consideration to which it will be entitled on the basis of this experience.

Though most commentators agreed with this principle, many nevertheless identified practical difficulties.

A first problem raised by commentators concerned the notion of 'variable consideration'. The examples illustrating this notion in paragraph 53 do not seem adequate to defining it beyond dispute. In particular, the term 'contingencies' posed a problem: does this apply only to consideration that is dependent on events outside of the control of the entity?

Other difficulties were also raised on the following topics:

- the use of the term 'reasonably assured': this term is used elsewhere in IFRSs, US GAAP and auditing requirements, and may create confusion. Further, where judgements are required, diversity may be created in practice;
- the fact that experience is said to be 'predictive' of the consideration to which an entity will be entitled: some commentators claimed that this notion is too vague and may be too liberally interpreted;
- the existence and the scope of paragraph 85, which states that income from fees from intellectual property (e.g. licences to patents and trademarks) can only be recognised as the customer's subsequent sales occur if the amount of consideration is based on the customer's subsequent sales of a good or service: some commentators suggested that this paragraph was too 'rule-based' and should be addressed by clarifying the principles in paragraph 81. Many commentators also noted that this exemption to the general principle, retained by the two Boards, should be expanded to include other transactions with similar economic circumstances. This paragraph thus only received support from the pharmaceutical, technology and software industries;
- the interaction between the constraint on the cumulative revenue recognised and the principle of measuring the transaction price: this two-step process is complex to apply. Worse, some have indicated that they perceive an inconsistency, given the contradiction between the measurement of variable consideration based on the 'most likely' amount (one of the two methods authorised, along with 'expected value') and the constraint on the amount that the entity is reasonably assured to be entitled to. Some acknowledge that this inconsistency is in part due to ambiguity over the unit of account for the constraint – that is, does it apply at the performance obligation level, contract level or a portfolio level.

Accounting for customer credit risk

According to the new exposure draft, the promised consideration which an entity regards as unrecoverable due to customer credit risk would be presented in profit or loss, on a separate line adjacent to revenue.

Overall, commentators welcomed the improvement made on the first exposure draft which, it will be remembered, proposed that the transaction price should be measured taking account of the customer credit (this risk would therefore have a direct impact on the revenue recognised).

However, few were in agreement with the Boards' new proposals for the presentation of customer credit risk in profit or loss, and many alternatives were put forward, generally proposing that expenses associated with customer credit risk should be presented as administrative expenses, and that any supplemental information should be reported in the notes to the financial statements.

Time value of money

This subject was not specifically addressed in the second ED of November 2011. Nevertheless many respondents commented that they agreed that the promised amount of consideration should be adjusted to account for the time value of money, if the contract contains a significant financing component. However, most of the letters invited the two Boards to provide more guidance on the identification of significant financing components. Failing this, the principles of

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the second exposure draft might not be applied consistently from one contract to another.

The practical expedient in the exposure draft, which states that an entity is not obliged to adjust the amount of promised consideration to reflect the time value of money if, at contract inception, the entity does not expect the interval between the time when the customer pays all or almost all the promised consideration and the time when the goods or services are supplied to exceed one year, received a mixed response. Many expressed concerns that the expedient was arbitrary, and inappropriate in some circumstances (e.g. to contracts in high-inflation economies).

Finally, respondents feared that the proposals of the two Boards would be very complex to implement, particularly for long-term contracts or contracts with separate performance obligations whereby goods or services are transferred at various points in time and the timing and amount of cash inflows from the customer does not correspond with the transfer of those goods or services.

➤ Summary of comments on other core proposals in the second exposure draft on Revenue Recognition

Onerous performance obligations

The IASB/ FASB proposals were once again the subject of lively and almost unanimous criticism, despite the simplifications of the scope of the onerous test proposed in the second exposure draft.

It will be remembered that, in the case of a performance obligation satisfied over time which the entity expects to satisfy in a period exceeding one year, the entity shall recognise a liability and a corresponding expense if the performance obligation is onerous.

Almost all the commentators disagreed with the proposal that the onerous nature of a contract should be assessed for each separate performance obligation. They believed that it would be economically counter-intuitive to recognise a loss on a part of a contract, when the contract as a whole is profitable.

Many stakeholders also disagreed on the fact that the onerous test should only be conducted on performance obligations satisfied over a period of time greater than one year. This practical expedient appeared arbitrary. It would lead to a range of accounting treatments, depending on how control of the good or service took place.

Finally, many commentators disagreed with the measurement basis for determining whether a performance obligation is onerous. The second exposure draft states that a performance obligation is onerous when the transaction price is less than the lowest cost of settling the performance obligation; that is, the lower of

- (a) the costs that relate directly to satisfying the performance obligation by supplying the promised goods and services and
- (a) the amount that the entity would pay to exit the performance obligation if it could do so other than by supplying the promised goods and services.

Respondents observed that it is generally impossible for an entity to exit a performance obligation without exiting the contract as a whole. Some also noted that it is common practice to continue the contract to its conclusion rather than terminate it, even if it is onerous. An entity determining whether a performance obligation is onerous should therefore consider the costs to exit a performance obligation only if it actually plans to exit that performance obligation.

In the light of these generally negative comments, it will be particularly interesting to see what comes out of the redeliberations.

Interim and annual disclosures

It must be acknowledged that users and regulators on the one hand, and preparers and other stakeholders on the other, have divergent views on disclosures in the notes to financial statements.

Unsurprisingly, users and regulators have generally welcomed the proposals in the second exposure draft aimed at

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improving disclosures on revenue recognition in both annual and interim financial statements.

However, preparers and other stakeholders (national accounting standard boards, auditors etc.) have denounced the very rigorous disclosure requirements set while the two Boards have failed to demonstrate that the expected benefits will exceed the costs of providing such information.

It will be remembered that the requirements in the second exposure draft should lead to a situation in which there are few differences between the interim and the annual accounts, which for preparers is in contradiction with the principles underlying IAS 34 on interim financial statements.

Transitional arrangements

The second exposure draft proposes retrospective application of the guidance with specified practical expedients.

Again, responses were divided.

- Users thought that the new text should be applied retrospectively,
- whereas preparers and auditors said that this would be impracticable. From the perspective of preparers, the costs of retrospective application would greatly exceed the benefits.

Alternatively, many stakeholders suggested that prospective application would be desirable, so that only contracts concluded from the effective date of the new standard should be accounted for in accordance with the new rules for revenue recognition.

Finally, if the transitional arrangements in the second exposure draft were to be retained, stakeholders asked that the delay between the publication of the new standard and the effective date should take into consideration the difficulties of the transition. This would entail mandatory application no earlier than 1 January 2016, assuming that the standard will not be published before early 2013 at best.

➤ Summary of comments on discrete issues that affect only some types of transaction or industries

Scope of the future Revenue Recognition standard

Although few respondents commented on the proposed scope of the exposure draft (there were no specific questions in the second exposure draft), nevertheless, based on their responses, the staff identified a few recurring themes that might warrant further consideration by the two Boards, including:

- the need to clarify the notion of 'collaborator' in paragraph 10 of the November 2011 exposure draft, according to which contracts with collaborators will not be covered by the standard;
- the interactions between this project and both the leases project and the impairment strand of IFRS 9.

Contract issues

Some respondents commented that the approach to the combination of contracts in the second exposure draft was too restrictive. Actually, it is not possible to combine contracts concluded with different customers, even if the contracts are economically linked (which some think would justify combination).

Generally, respondents indicated that the proposals for contract modifications are substantially improved from the 2010 exposure draft. However, many respondents think that the guidance is complex and difficult to understand.

Finally, some respondents feared that the proposals for unpriced change orders in the second exposure draft would delay the recognition of these modifications, since they could only be accounted for when the change affecting the

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subject of the contract had been approved, and the corresponding change to the price was likely to be approved.

Allocating the transaction price

The three main areas of comments on this point concerned:

- the need for further guidance and clarification on the allocation of the transaction price for particular types of arrangements (e.g. on the use of the residual method where a performance obligation in a contract includes goods or services with a very variable or uncertain price);
- the need for improvements to the proposal for allocating a discount to only one, or some, performance obligations in a contract, and not to the whole contract. These provisions were considered too restrictive and in the opinion of some could lead to outcomes that do not faithfully reflect the economics of the transaction. It should be remembered that as the draft standard currently stands, a discount can only be allocated to one or several separate performance obligations rather than to the performance obligations in the contract as a whole if the following two conditions are met:
 - the entity currently sells each good or service (or group of goods or services) in the contract separately; and
 - the observable stand-alone selling prices provide evidence regarding the performance obligation(s) to which the full contract discount applies;
- disagreement with the proposed basis for allocating the transaction price, expressed by entities from the telecommunications industry. The basis of allocation presented in the second exposure draft would significantly change the method (often described as the 'contingent cap') that almost all entities in the telecommunications industry currently use for contracts that bundle together a mobile phone handset with access mobile phone network services (i.e. revenue would in future be recognised at contract inception when a telephone is sold 'free' in a bundle, which is not the current practice).

Contract acquisition costs

The second exposure draft proposes that an entity recognise an asset for the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. However, an entity may use the practical expedient proposed by this text, and recognise those contract acquisition costs as an expense when incurred if the amortisation period for the asset would have been one year or less.

This proposal attracted some criticism due to the particular needs of some industries. The software industry in particular pointed out that for some complex long-term contracts, it will not always be possible to distinguish between costs associated with acquiring a contract and costs associated with fulfilling existing contracts.

Licences

The second exposure draft amended the proposals on licences contained in the first draft. The distinction between exclusive and non-exclusive licences was removed. The new proposals mean that revenue would be recognised when a licence or other rights of use were granted to a customer, as soon as the customer obtained control of the rights. If the entity has other performance obligations to satisfy under the contract, it must ask whether the promised rights constitute a distinct performance obligation or whether this obligation should be combined with other performance obligations in the contract.

In general, respondents directly concerned supported the direction of these changes. However, they pointed out that the proposals in the new exposure draft are too rule-based and that they would not reflect the economic substance of all transactions. Many respondents explained that the entity's performance often differs depending on the nature of the licence. Therefore, in some circumstances it is not possible to assume that the entity's performance is complete upon the transfer of the licence. This assessment does not depend solely on whether a service is rendered in addition to

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the transfer of the licence.

➤ What can we expect in the coming months?

Redeliberations will start in July 2012. The following areas will be addressed:

- Criteria for the identification of separate performance obligations;
- Criteria for identifying when a performance obligation is satisfied over time;
- Accounting for onerous performance obligations.

The IASB and the FASB have once again set themselves an ambitious timetable with the aim of publishing a joint standard on Revenue Recognition. This publication is unlikely to appear before Q1 2013, at the earliest.

Frequently asked questions

IFRS

- Loss of significant interest without change in ownership interest;
- Increase of ownership interest in a joint venture;
- Recognition of a liquidity commitment to a majority shareholder in an associate;
- Classification of an IT hardware lease;
- Outsourcing contract: does the entity act as agent or principal?
- Recognition of an option to shareholders for the payment of dividend in the form of shares.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB

16 - 20 July 2012

24 - 28 September 2012

25 - 16 October 2012

Committee

10 - 11 July 2012

18 - 19 September 2012

13 - 14 November 2012

EFRAG

23 - 25 July 2012

5 - 7 September 2012

3 - 5 October 2012

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