

Beyond the GAAP

No 36 - July August 2010

Editorial

There's no danger of boredom this summer! After the revenue recognition exposure draft published at the end of June, the IASB published on 30 July its exposure draft on insurance contracts - two exposure drafts that have been eagerly awaited for some months now. These publications are joined by the staff draft on financial statements presentation, a new stage before an exposure draft in early 2011.

In this double edition, DOCTR'in will outline the main points of these three publications.

Enjoy your reading, and your holidays!

Michel Barbet-Massin

Jean-Louis Lebrun

Contents

Highlights

- IFRS News **page 2**
- European matters **page 3**

A Closer Look

- IFRS 4 phase 2: exposure draft at last! **page 5**
- Puts on non-controlling interests: an amendment to IFRSs rather than just an Interpretation? **page 9**
- The IASB project on revenue recognition in 15 Q&A **page 11**
- IASB publishes a staff draft as part of the project on Financial Statements Presentation **page 19**

Events and FAQs **page 24**

Editors-in-Chief:

Michel Barbet-Massin, Jean-Louis Lebrun

Columnists:

Edouard Fossat, Patrick Le Flao, Carole Masson, Didier Rimbaud, Maxime Simoen, Arnaud Verchère and Fabienne Colignon, Practice Fellow seconded to the IASB by Mazars.

Contact us:

Mazars
Exaltis, 61, rue Henri Régnault
92 075 – La Défense – France

News

The SMEs Implementation Group appointed

The Trustees of the IFRS Foundation have published the names of members of the SMEIG (SME Implementation Group). The SMEIG is composed of 21 members chosen from the 89 applications received, and is chaired by Paul Pacter, Board member since 1 July 2010 and former Director of Standards for Small and Medium-Sized Entities (SMEs). In addition, there are two observers: the European Commission and the EFRAG. Mazars partner Steven Brice, head of the technical department in the United Kingdom, has been appointed for two years.

The role of the SMEIG is to encourage the international adoption of the IFRS for SMEs and to monitor its implementation.

The SMEIG will have two main tasks:

- to develop application guidance in the form of questions and answers, and
- to make recommendations to the IASB when it appears necessary to amend the IFRS for SMEs.

Therefore, the role of the SMEIG is similar to that of the IFRS Interpretations Committee (formerly IFRIC), applied to the IFRS for SMEs.

IFRS News

➤ The IASB resumes discussions on Rate-regulated Activities

At its meeting in July 2010, the Board decided that the project on rate-regulated activities was overly complex and should not be rushed into a definitive standard.

In July 2009, when opening the exposure draft to public comments, the Board intended to finalise within a year a standard on the accounting for regulatory assets and liabilities, in the specific context of cost-of-service regulation.

In February 2010, given the exceptionally high number of comment letters received and the fact that comments were equally split on the scope and on the recognition of balance sheet items, the Board directed the staff to do more research and outreach efforts.

Taking into account the results of this further work, the Board admitted at its meeting in July 2010 that it had difficulties in reaching a consensus on the key questions of:

- the existence of regulatory assets and liabilities,
- whether such assets and liabilities should be recognised in accordance with the current Framework, and
- whether recognition of such assets and liabilities is consistent with other current IFRSs, namely IAS 38 on intangible assets.

Therefore the Board asked the staff to continue to work on the project while acknowledging existing guidance and focusing on current practices worldwide.

➤ Fair value hedging: the IASB moves the debate forward

During July 2010, the IASB continued to discuss how the IAS 39 provisions for hedge accounting should be revised. Discussions address the question of the future of fair value hedging.

On this point, the IASB had tentatively decided in September 2009 to simplify fair value hedging by setting out an approach similar to that applied to cash flow hedging.

In the intervening period, many criticisms have been expressed in the belief that this solution would considerably increase the volatility of equity.

In July 2010, the IASB finally decided to explore another route. In the case of fair value hedging, an entity should present on a separate line in the statement of financial position (in assets or liabilities, depending on whether the hedged item is an asset or a liability), the cumulative gain or loss on the hedged item attributable to the risk being hedged. The carrying amount of the hedged asset or liability would thus not be adjusted. This would be similar to the approach already authorised in IAS 39 in the case of fair value hedging when hedging the interest rate risk on a portfolio of financial assets or liabilities.

Changes in the fair value of the hedging instrument and of the hedged item would impact other comprehensive income for the effective part of the hedge. The ineffective portion of the hedge would be immediately transferred to profit or loss.

It is not certain that this new approach will meet one of the IASB's objectives, a reduction in the complexity of hedge accounting.

European matters

➤ CESR: 8th extract from the database of enforcement decisions

On 13 July, the CESR (Committee of European Securities Regulators) published the 8th extract from its database of enforcement decisions, making public 13 decisions taken by the European regulators, on the following topics:

- fair value of financial instruments;
- disclosure on financial instruments;
- current/non-current classification of assets and liabilities;
- impairment testing of intangible assets;
- disclosures on impairment of intangible assets;
- intangible assets – football agents' commissions
- revenue recognition;
- impairment of trade receivables;
- disclosure on financial instruments - liquidity risk;
- earnings per share - determination of the weighted average number of ordinary shares in circulation;
- related party disclosures;
- presentation of the income statement;
- impairment testing of assets - determination of the discount rate.

These decisions can be accessed on the CESR web site:
<http://www.cesr.eu/popup2.php?id=6979>

➤ Adoption of IFRIC 14 amendment

The European Commission has adopted the amendment to IFRIC Interpretation 14 entitled *Prepayments of a Minimum Funding Requirement*, (Regulation (EU) No 633/2010 of 19 July 2010).

This amendment, published by the IASB on 15 November 2009, permits to recognise early payments as an asset when a plan is subject to a minimum funding requirement.

This text is applicable to annual periods starting as of 1 January 2011. Early application is permitted.

The regulation can be consulted on:

<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:186:0010:0013:EN:PDF>

➤ Adoption of IAS 24 R

The European Commission has adopted IAS 24R on Related Party Disclosures, published by the IASB on 4 November 2009.

IAS 24R simplifies the disclosures to be made by government-related entities, ie entities that are controlled, jointly controlled or significantly influenced by a government¹, and clarifies the definition of a related party (see IFRS News, DOCTR¹ in no 49, November 2009).

This text is applicable retrospectively to annual periods starting as of 1 January 2011. Earlier application is permitted, either of the whole Standard or of the partial exemption for government-related entities.

Regulation (EU) 632/2010 of 19 July 2010 may be consulted on:

<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:186:0001:0009:EN:PDF>

¹ The term 'Government' refers to government, government agencies and similar bodies whether local, national or international.

➤ Adoption of IFRIC 19 Interpretation

The European Commission has adopted the Interpretation IFRIC 19 entitled *Extinguishing Financial Liabilities with Equity Instruments* (Regulation (EU) No 662/2010 of 23 July 2010).

This interpretation, published by the IASB in November 2009, clarifies the accounting when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor (referred to as a "debt for equity swap").

IFRIC 19 is applicable to annual periods starting as of 1 July 2010. Early application is authorised.

The regulation can be consulted on:

<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:193:0001:0005:EN:PDF>

IFRS 4 Phase 2: at last, the exposure draft!

➤ A project in two phases

Insurance contracts include a very wide range of contracts, from property and casualty insurance that provides protection against an unfavourable event, to savings contracts that are closer in nature to financial investments. This diversity is reflected in their accounting, regulatory and actuarial treatment, in accordance with models that may vary significantly from one geographical area to another.

The IASB has addressed the accounting treatment of this diversity with the aim of publishing a standard devoted to these contracts that is simultaneously consistent with other IFRSs and reflects the economics of insurance contracts in a relevant way.

The task proved to be a difficult one. The first work, almost ten years ago, led to the publication of a Draft Statement Of Principle (DSOP), a stage preliminary to the publication of the standard.

Facing strong criticism of a text that focused on liabilities at fair value, the IASB took time to think of it and split the project into two stages:

- phase 1 ended in 2004 with the publication of IFRS 4 *Insurance Contracts* that only offered a temporary solution as it proposed for entities adopting IFRSs to maintain the accounting principles of their previous GAAPs for the treatment of insurance liabilities;
- phase 2, that was initially expected to be finalised in 2007, led to a Discussion Paper published in May 2007 and an exposure draft published on 30 July 2010.

The IASB currently aims to publish the final standard in 2011, for application in 2013-2014.

➤ Phase 1: a transitional standard

The current IFRS 4 (phase 1) is essentially the result of a compromise aiming to adapt, without drastic revision, the recognition of insurance contracts to the requirement to measure financial assets at fair value. Insurance liabilities continue to be recognised following the local GAAPs applicable for each insurance entity.

A deferred profit-sharing mechanism makes it possible to recognise the potential rights of the policy holder on the unrealised gains and losses on financial assets as if they had been realised. That mechanism limits the "mismatch" between financial instruments recognised at fair value and insurance liabilities recognised under local GAAPs.

Therefore, this transitional standard does not permit comparability between insurers because insurance liabilities continue to be measured according to local rules - with significant differences in the level of prudence when measuring insurance liabilities that generally follows the specific requirements of local regulations.

➤ Phase 2, still in progress

One of the first stages in phase 2 was the publication of a Discussion Paper in May 2007. The DP focused on recognition of insurance liabilities at their 'current exit value' (the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity).

Three years later, and following the reactions of stakeholders to the use of the current exit value for liabilities that are usually not transferred, the IASB's exposure draft proposes to use a 'fulfilment value' (the cost of fulfilling the insurer's obligations - see below).

➤ Key points of the exposure draft

Definition of an insurance contract and scope of the exposure draft

The definition of an insurance contract remains close to that in IFRS 4 Phase 1. Some amendments have been made, in particular regarding the factors to be taken into account when assessing significant insurance risk: current values, and no longer absolute values. The Board anticipates no material impact from this change.

Some contracts, such as fixed-fee service contracts or product warranties (such as manufacturers' guarantees), are by nature excluded from the exposure draft. The exposure draft therefore appears to seek to exclude contracts that have the characteristics of insurance contracts, but are issued by other industries.

The treatment of French savings contracts with discretionary participation features addressed by IFRS 4 in phase 1 requires clarification. Insurance contracts with discretionary participation features are included in the scope, provided that they participate in a pool of assets similar to insurance contracts.

Nevertheless, the requirement to unbundle the components of contracts in the scope of the ED when the components are not closely related to the insurance coverage specified in the contract could require the partial unbundling of savings contracts. An explicit case given in the exposure draft is when a contract has a specific account credited on the basis of the financial performance of a pool of assets.

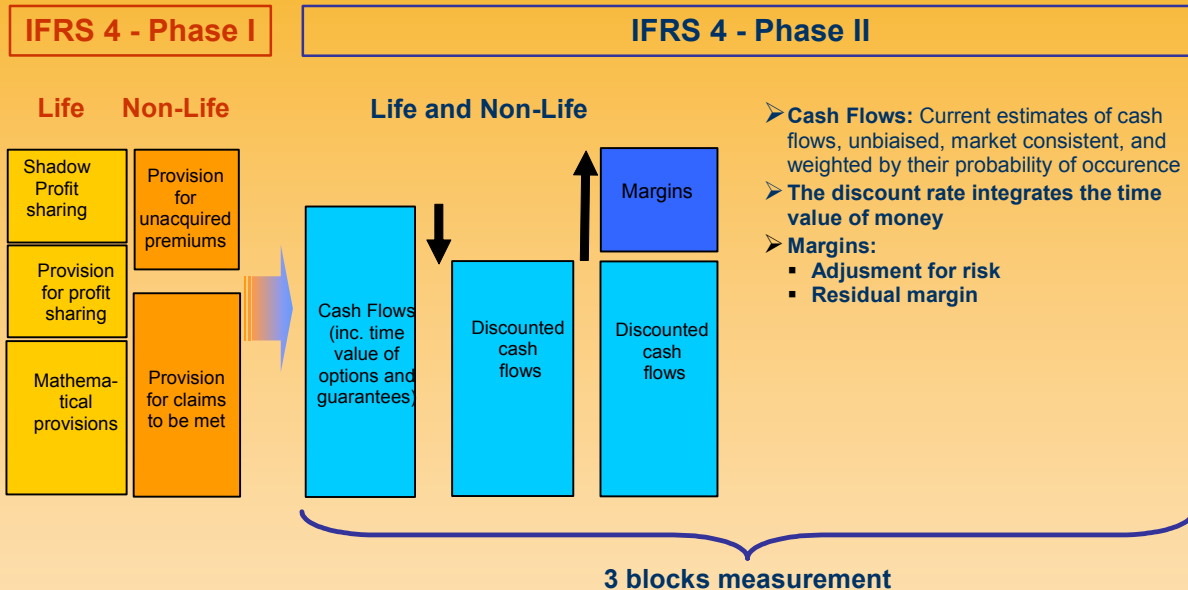
The FASB is clearly considering a divergent solution under which investment contracts with discretionary participation features are treated as financial instruments.

Measurement of liabilities

After long discussion, the Board has decided that an insurer should measure its liability based on the notion of "fulfilment value", i.e. the costs incurred to fulfil the insurer's obligations.

The liability is measured on the basis of a single model, regardless of the type of contract (life, non-life etc.), composed of building blocks:

- the future cash flows that will arise as the insurer fulfils the insurance contract using a probability-weighted average approach,
- the time value of money,
- an adjustment for risk,
- a residual margin.



This approach means that profit would not be recognised at the inception of the contract, the residual margin being based on the premium paid by the policy holder (except in the case of losses at inception).

Acquisition costs would be recognised as expenses, except for costs directly related to the sale of the contract that would be included in the measurement of the insurance liability (an IASB approach not shared by the FASB).

The first element in the building blocks, the future cash flows, would integrate all the cash flows relating to the current insurance contract (premiums, claims, costs etc.) with a more economic approach to future cash flows than that presented in the Discussion Paper:

- cash flows arising from options in current contracts would be taken into account reflecting their probability;
- the boundary between current contract and future contract would correspond to the moment at which the insurer is no longer obliged to provide insurance cover, or has the option to remeasure the risk associated with the policy holder,
- future profit-sharing cash flows would also be included (a divergent approach for the FASB relying on the notion of constructive obligation).

If the cash flows from an insurance contract do not depend on the performance of specific assets, the discount rate only reflects the characteristics of the liability and should be the risk-free rate, adjusted by an illiquidity premium. If the cash flows depend on the performance of particular assets, the discount rate should take that into account.

The approach chosen will generate more volatility in the income statement: all changes in financial and insurance parameters will directly impact the discounted cash flows, and thus the income statement. Adjustment for risk and residual margin is not intended to be used as a shock absorber.

Adjustment for explicit risk

The exposure draft suggests conducting an explicit risk margin measurement (to deal with uncertainties regarding cash flows), remeasured at each reporting date, to which is added a residual margin calculated at inception on the basis of premium and not remeasured.

The FASB takes a different approach, and favours a single composite margin, based on the premium, with no separate risk margin and without remeasurement at each reporting.

For European insurers, establishing a risk margin has the advantage of ensuring some consistency with the Solvency II standard. Appendix B of the exposure draft restricts the methods of calculating the risk margin to three approaches, Cost of Capital, Value at Risk, and Tail Value at Risk.

Calculations would be conducted on portfolios with a definition identical to that in IFRS 4 (contracts subject to broadly similar risks and managed together as a single portfolio).

Presentation in the income statement

The ED focuses on an analysis of margins, i.e. an analysis of changes in each block. The income statement would therefore no longer show cash flows (premiums and claims).

Transitional impact

The transition will impact retained earnings, in particular:

- the difference between liabilities in phase 1 and phase 2 (without residual margin at the transition date),
- the derecognition of intangible assets relative to insurance contracts authorised under the former standard (deferred acquisition costs, insurance portfolio value).

If the insurer has previously adopted IFRS 9, it may reclassify assets previously measured at amortised cost into the fair value through profit or loss category.

What are the consequences?

The application of this draft insurance standard would lead to the recognition of all changes in insurance liabilities in profit or loss (as a result of changes in financial and non-financial parameters) and not in Other Comprehensive Income (OCI).

The use of margins such as the residual margin or the composite margin as shock absorbers would also be prohibited.

On the assets side, the simultaneous application of IFRS 9 would lead insurers to record their assets at fair value in profit and loss, in order to avoid an accounting mismatch with the liabilities.

Looking at indicators such as the MCEV (Market Consistent Embedded Value, similar to a full economic statement) during periods of financial disruption, the volatility arising from the application of IFRS 4 phase 2 and IFRS 9 would be important and seems to run counter to insurer's long-term vision of their business model.

The comparability of insurers' financial statements will also be a major issue - in particular the determination of the risk margin, and IFRS - US GAAP divergences.

Puts on non-controlling interests: an amendment to IFRSs rather than just an Interpretation?

At the May 2010 meeting the IFRS Interpretations Committee (formerly the IFRIC) decided to add to its agenda the question of put options granted to non-controlling interest shareholders in a controlled entity ("NCI puts").

The 72 pages of papers prepared by the staff for the July meeting covered several aspects of the accounting for non-controlling interest puts, including initial recognition, subsequent measurement, the treatment of dividends paid by the subsidiary and the expiration or settlement of the put.

At this stage, the question of the scope of the interpretation remains open, but a minimum scope has nevertheless already been proposed by the staff. At its September meeting, the Committee will consider the implications of the NCI put being written as part of the takeover of a subsidiary, and any consequences on the accounting treatment of the put.

➤ General approach

The staff proposes to recognise a financial liability at the discounted value of the exercise price. The proposed cross-entry depends on the analysis on the transfer to the entity of the risks and rewards of the shares that are subject to the put.

If, when the put is written, the parent acquires a present access to the risks and rewards associated with the shares, the NCI (non-controlling interests, formerly minority interests) is derecognised, and the difference between the amount of the liability and the amount of the NCIs is deducted from controlling interest equity, as though it were merely an acquisition.

➤ Initial recognition

If the parent does not benefit from the risks and rewards associated with the shares, the staff envisages three approaches.

The first approach, preferred by the staff, consists of (a) maintaining the NCI in the statement of financial position and (b) recognising the liability against the group's equity.

The second approach consists of (a) derecognising the NCI totally, and (b) allocating the difference between the liability and the derecognised NCI in the controlling interest equity (i.e. as in the case where the group acquires access to the risks and rewards of the shares that are subject to the put).

The third and final approach proposes (a) eliminating the NCI while continuing to consider that it exists, *inter alia* for the purposes of allocating profit between the parent and subsidiaries, and (b) allocating to the controlling interest equity the difference between the liability and the NCI (i.e. as if the third party had exercised its put option),

The Committee has not yet reached a decision on the question of the initial recognition of a put, and is due to continue its work at the September meeting.

⇒ Changes in the value of the liability after initial recognition

On subsequent measurement, the staff and a large majority of Committee members favour changes in the value of the put liability recognised through profit or loss (as IAS 32 refers to IAS 39 for subsequent measurement).

An alternative view consists of recognising changes in the put liability in equity (i.e. an approach based on the provisions of IAS 27R relating to the acquisition of equity instruments).

⇒ An amendment to IFRSs rather than just an interpretation?

Apart from the issues considered, the Committee may also consider at its next meeting whether an amendment to IFRSs is preferable to an Interpretation. The objective would be to establish consistent accounting treatment, taking into account the different situations at different stages in the life of the put (issue, changes in value and expiration/exercise of the put).

In the common circumstance that the exercise price of the put is based on the fair value of the shares at the exercise date, an amendment to IFRSs could avoid the counter-intuitive recognition of increases in the liability as expenses, while on the one hand these increases are due to the good performance of the parent's management, and on the other hand the purchase price is a 'normal' price.

It should be reminded that it is these sort of counter-intuitive provisions in IFRSs that led to the development of alternative approaches, considering that no impact on profit or loss should normally be recorded. This view, highlighting the fact that the purchase of non-controlling interests is an equity transaction that should therefore not normally affect the profit or loss, was initially accepted and then clearly recommended by the AMF (see AMF recommendations for 2009).

We will keep you informed on the progress of this sensitive project.

Subscribe to Beyond the GAAP

Beyond the GAAP, MAZARS' monthly newsletter on accounting standards is 100% free.

To subscribe, send an e-mail to doctrine@mazars.fr including:

- Your first and last name,
- Your company and position,
- Your e-mail address

You will begin receiving Beyond the GAAP the following month by e-mail in pdf format.

If you no longer wish to receive Beyond the GAAP, send an e-mail to doctrine@mazars.fr with "unsubscribe" as the subject of your message.

The IASB project on revenue recognition in 15 Q&A

In July 2010 the IASB published, as part of its joint project with the FASB, an Exposure Draft on revenue recognition entitled *Revenue from Contracts with Customers*.

This ED sets out the main provisions of a future standard that should replace IAS 18 *Revenue* and IAS 11 *Construction contracts* by 2011. It is proposed to adopt a single revenue recognition model that could be applied to construction contracts, sale of goods and services.

The principles contained in the ED are in line with the model proposed in the Discussion Paper published in 2008 and the subsequent tentative decisions taken by the IASB.

For more details, see DOCTR'in of December 2008 (DP) and March 2010 (update on project progress).

Round tables will be held during the second half of 2010 and a definitive standard is expected in the second quarter of 2011. This standard will not be of mandatory application before 2013.

The application of the future standard will be fully retrospective. The IASB has not yet indicated whether early application will be permitted.

Given the significant impact of the project for many entities, DOCTR'in presents the main principles of this Exposure Draft in the form of questions and answers.

1. What is the scope of the ED?

The scope of the ED is very broad and applies to all contracts with customers.

However, the following are excluded:

- leases¹ (that fall within the scope of IAS 17);
- insurance contracts² (that fall within the scope of IFRS 4);
- financial instruments (that fall within the scope of IFRS 9 or IAS 39);
- certain non-monetary exchanges³.

¹ The IASB is due to publish an exposure draft to replace IAS 17 during the third quarter of 2010.

² See the special study on the ED "Insurance Contracts" in this issue.

³ Reflecting the existing exception in IAS 18 regarding exchanges to facilitate sales to customers (e.g. in the oil and dairy sectors).

2. What is the main principle underpinning revenue recognition?

According to the ED, revenue should reflect the transfer of goods and services to customers for an amount corresponding to the consideration that the entity receives, or expects to receive, in exchange for these goods or services.

In principle, **the recognition of revenue rests primarily on the notion of the transfer of control** of the good or service that is the subject of the contract, while the concept of the transfer of risks and rewards (used in IAS 18) no longer arises in the ED.

According to the ED, the entity should:

- identify the contract(s) to which the ED applies (see question 3);
- identify the separate performance obligations (i.e. the different components) of the contract (see question 5);
- determine the transaction price (see question 6);
- allocate the transaction price to the separate performance obligations (see question 7);
- recognise revenue (relating to each performance obligation) when the entity satisfies each performance obligation (see question 8).

3. How should the contract(s) to which the ED applies be identified?

The provisions of the ED should be applied separately to each contract. However, in some cases contracts should be segmented or combined to reflect the substance of the transaction.

Thus, an entity should combine several contracts when the transaction prices of the contracts are interdependent (for example, when the contracts are negotiated as a single package).

Conversely, an entity should segment a contract when the transaction prices of the different goods and services are independent, i.e. when the two following conditions are met:

- the entity (or another entity) regularly sells identical goods and services separately;
- the customer does not receive a significant discount for buying some goods or services together with other goods and services in the contract.

As indicated in question 5, the ED has similar provisions for the separation of the different performance obligations within a contract.

4. How should contract modifications be treated?

A contract modification is any change in the scope or price of a contract.

When the prices of the modification and the existing contract are interdependent (as described in question 3), an entity must retrospectively adjust the accounting for the existing contract. Hence, the cumulative impact of the modification should be recognised as if the modification had been taken into account from the inception of the contract.

If the prices are independent, the entity should account for the contract modification as a separate contract.

Appendix B offers an example of the application of this principle. The notion of interdependence as illustrated in this example is not very clear.

5. How should the separate performance obligations in the contract be identified?

This issue has already been addressed repeatedly by the IFRIC (in particular in IFRIC 13 on customer loyalty programmes and IFRIC 15 on agreements for the construction of real estate).

The ED proposes to adopt an approach consistent with that of the IFRIC by identifying and recognising separately the revenue linked to each component of a contract, called a 'performance obligation'.

A performance obligation corresponds to an undertaking to transfer a good or service to a customer.

The identification of different performance obligations is of key importance because it determines the pattern of revenue recognition.

If an entity undertakes to transfer several goods or services within a contract, the entity must recognise each good or service as an independent performance obligation if it is distinct. If a good or service is not distinct, the entity must combine this good or service together with other goods and services until the entity can identify a bundle of goods and services that is distinct.

A good or service (or a bundle of goods and services) is distinct if:

- the entity, or another entity, sells identical or similar goods and services separately; or
- the entity could sell the good or service separately because it fulfils the following two criteria:
 - it has a distinct function. A good or a service has a distinct function if it has a utility either on its own or together with other goods and services that the customer had acquired from the entity or that are sold separately by the entity or by another entity; and
 - it has a distinct profit margin. A good or service has a distinct profit margin if it is subject to distinct risks and if the entity can separately identify the resources needed to provide the good or service.

This definition may require a contract to be broken down into multiple performance obligations. For example, in the case of a contract for the construction of real estate, it may be possible to find an entity that could sell the different services necessary to the construction of real estate separately.

Appendix B (B43) provides an example of identifying performance obligations which seems complex and subjective to implement. This breakdown could prove to be tricky.

However, the ED states that in the case that goods and services are transferred on the same time, it is not necessary to break down the contract, the recognition of revenue being unaffected by the bundling of the different performance obligations (however, see question 12 on onerous contracts).

Appendix B of the ED contains application guidance on this principle of identification to performance obligations. Some of these examples are presented below (see questions 9, 10 and 11).

6. How should the transaction price be determined?

According to the ED, the total revenue that an entity may recognise corresponds to the transaction price agreed in the contract (discounted when necessary).

The recognition of revenue based on fair value (or an exit price), at one time proposed by the IASB, has therefore been abandoned for contracts within the scope of the ED.

The transaction price includes, as necessary, discounts and rebates, the amounts ('refunds') that the entity expects to pay to the customer, performance penalties or bonuses or other variable amounts.

Therefore, in contrast to the existing practice, **variable amounts should be recognised on the basis of estimates that may be revised** (based on the expected value of the various possible outcomes).

However, an entity should recognise such variable amounts only if it can identify the transaction price can be reasonably estimated. That would be the case if the entity:

- has experience of similar types of contracts ;
- and has no reason to believe that the circumstances under which these contracts are performed have changed.

The transaction price would also take into account, as appropriate:

- the customer's credit risk (in contrast to current practice);
- the time value of money, in the event of deferred payment;
- consideration paid to the customer when it relates to a reduction in the transaction price and not the acquisition of a distinct good or service.

7. How should the transaction price be allocated to the separate performance obligations?

The ED states that if the contract contains several performance obligations, **the transaction price is allocated to each performance obligation in proportion to the transaction price of each good or service relating to these obligations.**

The transaction price of each good or service corresponds to the price at which the entity could sell this good or service separately.

This transaction price should first be evaluated with reference to observable market prices if such exist. Otherwise, the transaction price should be evaluated:

- either by evaluating the expected necessary costs of fulfilling the obligation, adding the margin that the entity demands for similar goods or services;
- or by adopting market prices, adjusted when necessary to reflect the structure of costs and margins in the entity.

The allocation of the contract transaction price to each performance obligation should make it possible to determine a separate margin on each performance obligation, even though the price was negotiated for the elements taken as a whole. This point constitutes a significant change from the current provisions of IAS 11. These measures for breakdown and allocation could also have a considerable impact on the provisions for onerous contracts (see question 12).

8. When should the revenue allocated to a performance obligation be recognised?

The ED states that the revenue allocated to a performance obligation (i.e. a component of the contract) is recognised when control of the good of service that is the object of the performance obligation is transferred.

This transfer of control may be continuous and could therefore cover the situations of continuous transfer of control described in IFRIC 15 *Agreements for the Construction of Real Estate* (applied in France in the case of 'VEFA' contracts that are contracts for the purchase of property not yet complete in which legal title passes to the customer as work progresses).

According to the ED, control of an asset should be defined as the ability of the customer to direct the use of, and receive the benefit from, the good or service.

In practice, the ED provides a number of indicators to assess whether control has passed (continuously or otherwise):

- The customer has an unconditional obligation to pay for the good or service (and the payment is non-refundable).
- The customer has legal title to the goods.
 - However, when an entity retains title solely to ensure that amounts can be recovered (a retention of title clause, for example), this does not affect the transfer of control.
- The customer has physical possession of the good.
 - However, in some consignment arrangements, the 'delivery' date does not coincide with the date control is transferred. Conversely, if in a 'normal' sale delivery is postponed at the request of the customer, control may be transferred even if the entity has physical possession of the good.
- The customer has specified the design or function of the asset.

If these criteria are met at a given date, for example on delivery of the good, the income will be recognised at that date (corresponding to the completion date).

If the transfer of control is continuous, revenue will be recognised using methods which may be based on:

- production, works carried out or services rendered to date, expressed as a percentage of the total production, works or services;
- costs incurred to date relative to total costs (excluding costs due to wastage);
- the passage of time.

An analysis will be required to assess the relevance of these indicators and to compare them with the actual contractual clauses. This analysis should make it possible to determine whether the income relating to construction contracts can be recognised as work progresses.

At this stage, it is difficult to reach a conclusion on this topic as, in a traditional construction contract, the various indicators are not all met. For example, a customer has specifically negotiated the design or function of a good but has no unconditional obligation to make payments until construction is complete. Would that be sufficient to conclude that control is transferred continuously?

In the case of contracts with continuous transfer, revenue would be recognised following a pattern similar to the stage of completion method currently used in IAS 11 and IAS 18. However, revenue recognition as proposed in the ED for such contracts may be different from current practice because of the breakdown of the contract into separate performance obligations.

9. How should the principles in the ED be applied to product warranties?

The ED distinguishes two types of product warranties depending on its objective:

- If the objective of a warranty is to provide a customer with coverage for latent defects in the product (i.e. defects that exist when the product is transferred to the customer but are not yet apparent), that warranty does not give rise to a separate performance obligation, but is part of the performance obligation to deliver the product. This type of guarantee includes **legal warranties**. The accounting treatment would result in the “neutralisation” of part of the revenue representing an estimate of the number of defective products and part of the goods “supplied” maintained in inventories (as if part of the products were placed on consignment with the customers) ;
- If the objective of a warranty is to provide a customer with coverage for faults that arise after the product is transferred to the customer (e.g. **optional warranties**), that warranty gives rise to a performance obligation for warranty services in addition to the performance obligation to transfer the promised product. Therefore, the entity should allocate the transaction price (on relative stand-alone price basis) between the promised product and the promised warranty service (see question 7).

10. How should the principles of the ED be applied in the case of sales with a right of return?

Some products are sold with the right of return, such as the right for a customer to withdraw from a transaction during a certain period.

The ED states that the right of return is not a separate performance obligation. In this case, the entity should:

- defer part of the revenue against a provision for refunds equal to the estimated value of expected refunds (expected value);
- periodically review this provision for refunds;
- recognise an asset representing the right to receive goods in return (based on expected value and the resale price of the products).

11. How should the principles of the ED be applied to sales with options to acquire additional goods or services?

The ED states that, when recognising revenue, options to acquire additional goods and services either free of charge or at a discount should be taken into account. That view reflects that of IFRIC 13 to customer loyalty programmes.

According to the ED, an option to acquire additional goods and services is a separate performance obligation if the option gives the customer a significant material right that the customer would not receive without entering into the contract.

A Closer Look

The stand-alone selling price for a customer's option to acquire additional goods or services often is not directly observable and must be estimated. That estimate should reflect the discount the customer would obtain when exercising the option, adjusted for the following:

- any discount that the customer could receive without exercising the option, and
- the likelihood that the option will be exercised.

It should be noted that these proposals are in line with those of the Discussion Paper on Leases for renewal options.

12. What principles apply to onerous contracts?

The ED states that **the onerous nature of a contract is assessed for each separate performance obligation**. This introduces a major change from current practice as the onerous nature is generally evaluated on the basis of the contract as a whole.

Thus, a performance obligation is considered to give rise to an onerous contract when the expected costs of satisfying the obligation exceed the transaction amount originally allocated. In this case a loss is recognised immediately for the difference. Thus the margin included in the amount allocated to each obligation will be cancelled before a loss is recognised.

The methods of allocating the transaction price set out in the ED could, in some cases, lead to recognise a provision for loss at completion relating to a performance obligation when entering into the contract if there are significant differences between the margins of the different performance obligations.

It should be noted that the Board's tentative decision to review the allocation of the transaction price in the event that the contract as a whole is profitable, such that no performance obligation is deemed to be onerous, has not been taken up in the ED. That decision will certainly provoke some discussion.

13. What is the accounting treatment for the costs incurred in obtaining a contract?

The ED states that **the costs of obtaining a contract** (incurred in selling, advertising and marketing), the costs of performance obligations already satisfied and the amounts relating to abnormal amounts of wasted materials or labour are **recognised immediately as expenses** when incurred.

This provision appears particularly strict in relation to the costs incurred in obtaining a contract when these costs are only due if the contract is concluded (e.g. an exceptional commission paid to an employee if the contract is obtained). In that event, the capitalisation criteria of IAS 38 appear to be satisfied, and an intangible asset should be recognised.

Other costs incurred in performing a contract, if they do not meet the definition of an asset in accordance with other IFRSs (e.g. inventory, tangible or intangible assets), will be capitalised if they generate a resource that the entity may use to satisfy its performance obligation, if they can be attributed to a contract (or future contract) and if they will be probably recovered.

It should be noted that in current practice (see IAS 11), costs incurred in obtaining a contract are capitalised if it is probable that the contract will be concluded.

A Closer Look

14. What disclosures should be provided in the notes?

The ED states that information in the notes on revenue should include:

- the different types of contracts concluded with customers, and their accounting treatment;
- the main judgements and assumptions reflected in the amounts recognised;
- a reconciliation from the opening to the closing aggregate contract balance, for those activities in which such a reconciliation is meaningful (long term activities, activities subject to uncertainty – variable or conditional revenue, etc.);
- onerous performance obligations and the reason why such performance obligation have become onerous.

15. To sum up: what are the key points?

If the ED would be adopted as it stands, the main changes from current practice would be as follows:

- the mandatory breakdown of the contract into much more detailed components than at present;
- the allocation of the transaction price to each component on the basis of market prices, leading to the recognition of a different profit margin on each component;
- the recognition of revenue when control of the good or service is transferred, such that revenue on some construction contracts could be recognised on completion (rather than by the 'stage of completion' method of IAS 11);
- recognising variable consideration based on a probability estimate (mean expectation of different hypotheses);
- including the customer credit risk when measuring revenue;
- recognising the impact of warranties and rights of return as a reduction of revenue (and not as an expense);
- recognising liabilities for onerous performance obligations, as appropriate, at the level of each contract component rather than for the contract as a whole (i.e. even if the contract as a whole is profitable);
- recognising the costs of obtaining the contract as expenses.

IASB publishes a staff draft as part of the project on the Presentation of Financial Statements

On 1 July, the IASB posted on line a staff draft of the exposure draft on the presentation of financial statements. This is an unusual process compared to the IASB due process and the intention is to present the decisions taken to date by the IASB regarding its project on presentation of financial statements. It will provide the IASB - and the FASB, since this is a joint project - with more time to consult stakeholders in order to assess the benefits and costs of the proposals.

Although the Board does not formally list the questions it would like stakeholders to answer, it welcomes comments from parties interested by the issues raised in the staff draft.

At the end of 2010, a summary of this 'fieldwork' will be made to assess the extent to which the exposure draft scheduled in early 2011 should be amended compared to the present staff draft.

As DOCTR'in pointed out in June 2010, the presentation of financial statements project is one of the major convergence projects in which progress has slowed down. It should lead to the publication of a final standard to replace IAS1 and IAS 7 by June 2011, a date set by the G20 for measuring the progress towards convergence achieved between IFRS and US GAAP.

DOCTR'in here presents the IASB's main proposals and the significant changes since the publication of a discussion paper on this project in October 2008 (comment period of six months). It should be remembered that the issue of presentation of other comprehensive income was the subject of a separate exposure draft published in May 2010 (see DOCTR'in of May 2010), while the DP also addressed that issue.

➤ The aim of the IASB and the FASB is to improve the usefulness of the information provided by financial statements in order to assist users in taking decisions

In making their proposals, the IASB and the FASB have taken two observations as their starting points.

1. Information is not presented consistently across financial statements

For a single event or transaction, the impact on the statement of financial position, the statement of comprehensive income or the statement of cash flows is not described or classified in the same way. This lack of consistency complicates the task of users of financial statements, who sometimes find it difficult to make links between the different statements.

The example in the staff draft introduction concerns the difficulty of making links between the cash flows from operating activities (as defined in IAS 7) when this concept of operating activities does not exist in IAS 1, in particular in presenting the statement of comprehensive income.

Further, options available for presentation harm comparability of financial statements across entities. For example, the cash flow statement can be presented in accordance with the direct or the indirect method.

2. Information is not sufficiently disaggregated in the financial statements

IAS 1 currently gives very few indications as to how information should be disaggregated, in particular in the statement of comprehensive income. It may therefore be difficult to compare the performance of two companies when the level of detail provided is not the same, for example regarding the operating costs incurred in a given period.

Similarly, the fact that a line item labelled "cost of sales" aggregates costs of different nature makes it difficult to link the statement of comprehensive income with the statement of cash flows as soon as that cost includes both cash and non-cash amounts.

Another difficulty identified by the two Boards is that there is no distinction in the statement of financial position between the changes in assets and liabilities resulting from remeasurement (either because of changes in prices or market rates) from other changes. However, the impact on future cash flows can be very different in those cases.

➤ What are the main proposals in the staff draft?

These observations led the IASB and the FASB to set out two fundamental principles underlying the new format for financial statements presented in the staff draft:

- cohesiveness: the information provided in financial statements should portray a cohesive financial picture of the entity's activities;
- disaggregation: the information should be disaggregated to explain the components of an entity's financial position and financial performance.

The objectives of financial statements concerning liquidity and financial flexibility have not been carried over from the DP.

The application of these two major principles would bring about the following changes, applicable regardless of the entity's industry (i.e. including financial institutions).

Classification and format of financial statements

In accordance with the cohesiveness principle, an entity's financial statements must present information regarding the same transaction or event in the same section, category or sub-category of each statement (i.e. the statement of financial position, the statement of comprehensive income and the statement of cash flows).

The staff draft identifies two sections:

- the business section, including an operating and an investing category;
- the financing section that includes the debt and equity categories. This section presents elements relating to obtaining and reimbursing capital.

The operating category is intended to include assets used in the entity's day-to-day business and all changes in those assets. This category should also include liabilities arising from the entity's day-to-day business, and all changes in those liabilities.

Some examples are provided in the staff draft illustrating the types of transactions to be included in this category: the sale of services by a consulting firm, cash received from customers, intangibles used in the entity's day-to-day business, etc.

The operating finance sub-category covers liabilities that are directly related to the entity's day-to-day activities, but which also provide a source of long-term financing for the entity, provided that they meet three conditions. The staff draft identifies, for example, provision for post-employment benefit obligations.

The investing category is intended to include the assets or liabilities which the entity uses to generate a return (dividends, royalties, gains and losses etc.)

As an example, the staff draft identifies dividends received on equity investments.

This category is therefore very different from the 'investment activities' category in IAS 7.

A Closer Look

The table below illustrates the presentation principles set out above:

| STATEMENT OF FINANCIAL POSITION | STATEMENT OF COMPREHENSIVE INCOME | STATEMENT OF CASH FLOWS |
|---------------------------------------|---|---|
| Business section | Business section | Business section |
| Operating category | Operating category | |
| Operating finance subcategory | Operating finance subcategory | |
| Investing category | Investing category | |
| Financing section | Financing section | |
| Debt category | Debt category | Financing section |
| Equity category | | |
| | Mutli-category transaction section | Mutli-category transaction section |
| Income tax section | Income tax section | Income tax section |
| Discontinued operation section | Discontinued operation section, net of tax | Discontinued operation section |
| | Other comprehensive income, net of tax | |

Source: IASB

The multi-category transaction section would be used in the statement of financial position and in the statement of cash flows to present the impact of complex transactions, such as a business combination or a sale of assets that does not constitute a discontinued operation (the latter belongs in a dedicated section).

It is the classification in the statement of financial position that will dictate the classification of the components of the changes in assets and liabilities in the statement of comprehensive income and in the statement of cash flows. The staff draft proposes that an asset or liability with multiple functions, for example a company's headquarters, should be classified in the section or category of predominant use.

When an expense or income item is recognised without the recognition of an associated asset or liability in the statement of financial position, the income or expense should be presented in the relevant section or category of the statement of comprehensive income, taking into account the nature of the activity generating it. Other elements in the statement of comprehensive income should be identified as belonging to the operating, investing or financing categories, or as discontinued operations. Only the CTA reserve would not be allocated.

Depending on the nature of the change in an asset or a liability, the cohesiveness principle should be applied line by line or to the category in which the asset or liability is recognised.

When an entity is engaged in several activities as per IFRS 8 (i.e. the entity has several reportable segments), an entity

A Closer Look

should classify the assets and liabilities associated with each of these activities in a way that reflects an analysis specific to each activity.

Finally, the staff draft states that an entity should retain the same presentation in sections and categories from one reporting period to the next, unless there are valid reasons for not doing so, for example a change in the use of the asset concerned.

Disaggregation of information in the financial statements

Statement of financial position

In the statement of financial position, short-term assets, long-term assets, short-term liabilities and long-term liabilities must be presented separately, or by order of liquidity if that presentation provides information that is more relevant.

An asset or a liability is classified as short-term when it has a contractual maturity of less than one year, or if it is expected that the asset will be realised or the liability settled within one year.

There would no longer exist the current/non-current distinction established in IAS 1 that makes reference to the normal operating cycle of the entity.

When the function, nature or measurement basis of assets and liabilities presented in a single category differs, they must be presented separately.

In practice, for example, it means that liabilities measured at amortised cost must be presented separately from those measured at fair value.

As for all the financial statements, sub-totals for each section, category and sub-category should be presented with related headings. An amount for total assets and an amount for total liabilities are also required. Finally, when an entity classifies and presents its assets and liabilities as short-term and long-term, it should also present total amounts for short-term assets, long-term assets, short-term liabilities and long-term liabilities.

Statement of comprehensive income

In each section and each category, income and expenses must be disaggregated by function.

The information must then be disaggregated by nature, either directly in the statement of comprehensive income or in the notes, as long as this information is relevant to measurement, timing and uncertainties relating to future cash flows.

The DP proposed disaggregation by function and then by nature in the statement of comprehensive income.

It should be noted that the FASB's proposal would require disaggregation by nature for each segment in the notes on reportable segments. The IASB did not want to take this route.

If disaggregation by function is not relevant, an entity may decide to disaggregate income and expenses by nature in the statement of comprehensive income.

Finally, an entity should present separately in the statement of comprehensive income the consequence of a significant event or transaction that occurs infrequently.

A Closer Look

Statement of cash flows

An entity should present the cash flows resulting from each section and category using the direct method. The indirect method of presenting cash flows resulting from operating activities, as currently permitted by IAS 7 and widely used, would thus be removed.

Furthermore, an entity should provide a reconciliation between the net operating result and the cash flows from operating activities in the same statement of cash flows.

An entity should disaggregate the information to present each type of cash inflows and outflows separately.

Information to be disclosed in the notes

The DP proposed to require preparers to reconcile cash flows to comprehensive income, by:

- disaggregating changes in assets and liabilities that impact the cash flows and those that do not;
- distinguishing, for non-cash changes, those changes that result from remeasurement and those that do not;
- finally, by disaggregating changes resulting from remeasurement into those that are recurring remeasurements and the other remeasurements.

Following the many criticisms received, the IASB has decided not to require that reconciliation table to be presented in the notes. However, some new disclosures are required by the staff draft that differ from those under IAS 1 with the aim to explain the main changes between opening and closing assets and liabilities. This analysis will distinguish between cash flows and non-cash flows, the effects of impairment and depreciation, the impact of acquisitions and disposals and the remeasurement component (changes in fair value or in exchange rate).

Finally, the staff draft proposes that these principles should be applied retrospectively, meaning that the changes ought to be anticipated !

Events/publications

Seminars on "Current developments in IFRSs"

Mazars' Technical Department will host a number of seminars throughout 2010 dedicated to current developments in IFRSs. These seminars, organised by Francis Lefèbvre Formation, will be held 24 September and 10 December 2010.

To register, please contact Francis Lefèbvre Formation – www.flf.fr, +33 (0)1 44 01 39 99.

Preparing the 2010 financial reporting under IFRSs

Mazars' Technical Department will lead a seminar on preparing the 2010 financial reporting under IFRSs on 20 October 2010 in Paris.

To register, please contact Francis Lefèbvre Formation – www.flf.fr, +33 (0)1 44 01 39 99

Frequently asked questions

IAS/IFRS

- Applying the combining criteria on two operating segments;
- Business combinations between entities under joint control;
- Partial disposal of the interest in a joint venture;
- Accounting for the loss on a disposal group held for sale when the non-current assets of the disposal group are not sufficient to absorb the loss.

Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

IASB

13 - 17 September 2010

18 - 22 October 2010

15 - 19 November 2010

Committee

2 - 3 September 2010

4 - 5 November 2010

6 - 7 January 2011

EFRAG

8 - 10 September 2010

6 - 8 October 2010

3 - 5 November 2010

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 18 August 2010

© Mazars – August 2010