The year just ended should have seen the publication of the final standards for the joint projects on financial instruments, revenue recognition, leases and insurance contracts. None of them have appeared! The second exposure draft on revenue recognition has only just been published, while redeliberations are continuing on leases, financial instruments and insurance contracts.

The delay is due to the magnitude of the task and the criticisms which greeted some of the IASB’s initial proposals. Over the course of the year, the IASB has repeatedly revised its work plan and deferred the publication date of the new standards, which are now expected in 2012. It remains to be seen whether this new target is achievable!

The editorial team of Beyond the GAAP wishes you a very happy New Year.
Publication of exposure draft on transition guidance in IFRS 10

The IASB decided last November to clarify the transition guidance in IFRS 10. As a result, on 20 December 2011 the IASB published its proposed amendments to IFRS 10 in the form of an exposure draft (ED/2011/7 Transition Guidance: Proposed amendments to IFRS 10). The comments period is open until 21 March 2012.

The exposure draft can be accessed via the link below: http://www.ifrs.org/NR/rdonlyres/14188A90-5D78-4FAB-B17A-90A14E43D9B4/0/EDTransGuidAmdIFRS10.pdf

Publication of amendments to IFRS 7 and IAS 32 on offsetting financial assets and liabilities

On 16 December 2011, the IASB published amendments to IFRS 7 and IAS 32 on the rules for offsetting financial assets and liabilities.

Readers will remember that these amendments are the outcome of an unsuccessful attempt at convergence between the IFRS and US GAAP rules on offsetting financial assets and liabilities. Having failed to reach a consensus on the subject, the two Boards finally decided to standardise the disclosures to be made in the notes, so that users of the financial statements would be able to carry out the recalculations necessary to obtain comparable financial data.

The amendment to IFRS 7 requires entities to present the gross amounts of financial assets and liabilities (i.e. before offsetting), the amounts offset, and the net amount presented in the balance sheet.

The IASB has also provided clarifications on the rules set out in IAS 32 on the offsetting of financial assets and liabilities.

The clarifications relate to the following issues:

- IAS 32 paragraph 42a stipulates that an entity must “currently” have a legally enforceable right to offset the recognised amounts. The amendment clarifies that this applies not only in the context of normal activity, but also in the event of the default or bankruptcy of the entity or its counterparties as.

- IAS 32 paragraph 42b stipulates that the entity must intend to either settle on a net basis, or realise the asset and settle the liability simultaneously. The amendment clarifies the conditions under which a “simultaneous” settlement on a gross basis meets the conditions of paragraph 42b.

Subject to adoption by the European Union, the amendment to IFRS 7 is obligatory for financial periods commencing on or after 1 January 2013, and the amendments to IAS 32 are obligatory for financial periods commencing on or after 1 January 2014 (early application is permitted). The amendments should be applied retrospectively.
Consolidation standards: EFRAG requests deferral of effective date

In a letter dated 9 December 2011, EFRAG requested that the IASB defer the obligatory effective date of IFRS 10 – Consolidated Financial Statements, IFRS 11 – Joint Arrangements and IFRS 12 – Disclosure of Interests in Other Entities, on the grounds that:

- EFRAG’s field-tests on initial application have confirmed that the effective date of 1 January 2013 would pose significant problems for consistent application; and
- the ongoing Investments Entities project and the exposure draft on amendments to transition guidance in IFRS 10 (published by the IASB on 20 December 2011) create uncertainty and could lead to excessive initial application costs.

For these reasons, and to allow issuers of financial statements to plan and implement the new standards in an orderly fashion, EFRAG suggests that the obligatory effective date should be deferred to whichever is the later of:

- 1 January 2014; or
- 12 months after the publication of the amendments to IFRS 10 and the Investment Entities standard.

EFRAG’s letter can be accessed via the link below:

Revenue recognition: EFRAG requests extension to comment period

In a letter dated 15 December 2011, EFRAG requested that the IASB extend the comment period for the new exposure draft on revenue recognition by 60 days. The exposure draft, ED/2011/6, A revision of ED/2010/6 Revenue from Contracts with Customers, was published on 14 November 2011.

EFRAG believes that the current comment period, which closes on 13 March 2012, is too short, primarily because it falls at a time when issuers are preparing their financial statements for 2011 and will thus not have sufficient internal resources to respond.

EFRAG has also asked the IASB to ensure that the comment period for the forthcoming review draft on hedge accounting is set at such a time as to give stakeholders three months, outside their year-end closing period, to respond to it.

EFRAG’s letter can be accessed via the link below:

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Financial Instruments project: last decisions of 2011

In December, the Board continued with its reflections on the proposed macro-hedging approach, but did not reach a decision on the subject. We will therefore look at the key decisions relating to the other phases of the IFRS 9 – Financial Instruments project.

**Limited modifications to phase 1 of IFRS 9: Classification and measurement of financial instruments**

As mentioned in our November issue, the IASB has decided to re-open discussion on certain aspects of classification and measurement in IFRS 9, in order to address:

- Some specific application issues identified thanks to the initial feedback;
- The interactions with the IFRS 4 – Insurance Contracts project;
- The FASB’s recent decisions on the classification and measurement of financial instruments.

This month, the Board specified the areas which require further work:

- Deciding whether additional application guidance is needed to clarify how analysis of an instrument’s characteristics should be taken into account in its accounting classification (amortised cost vs. fair value);
- If necessary, and taking account of the previous point, deciding whether it would be useful to reintroduce the concept of bifurcation of financial assets (a return to the embedded derivatives concept on asset side?);
- Considering expanded use of Other Comprehensive Income or the creation of a third business model for some debt instruments.

**Impairment of financial assets (Phase II of IFRS 9)**

At the joint IASB-FASB meeting on 14 December, the Boards continued to develop the relative model of depreciation based on expected losses, referred to as the three-bucket expected loss approach\(^1\). Tentative decisions were made on the following issues:

**Calculating impairment for assets in bucket 1**

The Boards confirmed that the impairment objective for bucket 1 assets was to capture the total losses expected over the next 12 months. The Boards also stated that these “expected losses” would include:

- the cash shortfalls over the next 12 months; and
- the lifetime expected losses on the portion of financial assets on which a loss event is expected over the next twelve months.

Thus, our understanding is that it will be possible to recognise an impairment loss on “zero coupon” type instruments allocated to bucket 1 with a maturity of more than one year. Obviously, the impairment amount would not represent the cash shortfalls expected over the next 12 months, given the contractual cash flow profile of the instrument. This approach aims to capture the future cash flow losses relating to changes in estimates which the entity expects over the next 12 months (e.g. when a credit event is expected over the next 12 months).

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\(^1\) For more details on the issues involved in this classification approach, see Beyond the GAAP nos. 48 and 49.
Timing of transfer from bucket 1

The IASB and FASB have stipulated the conditions which will require the transfer of assets from bucket 1 – to which all assets will be allocated upon initial recognition – to buckets 2 or 3.

The following tentative decisions have been taken on this issue:

- Assets must be reclassified from bucket 1 to buckets 2 or 3 when:
  
  - (a) there is a more than insignificant deterioration in credit quality since initial recognition; **AND**
  
  - (b) the likelihood of default is such that it is at least reasonably possible that contractual cash flows may not be recovered.

  - The final version of IFRS 9/ Phase 2 will include indicators of when an instrument should be transferred out of bucket 1.

Grouping of assets to evaluate whether transfer is appropriate

The Board believes that the analysis of the need to transfer assets out of bucket 1 may be carried out at the portfolio level, provided that the portfolio in question meets certain criteria. For example, the portfolio may only include assets with shared risk characteristics.

Assets which are individually significant and/or which cannot be included in a group of assets (e.g. because the entity does not have any other assets with similar risk characteristics) must be evaluated on an individual basis.

Moreover, the “portfolio” approach is to remain optional. Thus, an entity will still have the option of evaluating an asset transfer individually even if it meets the criteria to be included in an existing portfolio.

Difference between bucket 2 and bucket 3

The Board has confirmed the difference between bucket 2 and bucket 3. The latter will comprise assets transferred from bucket 1 for which impairment is calculated on an individual basis.

Application of the relative credit risk model to publicly-traded debt instruments and consumer loans

The IASB and FASB have tentatively decided not to require specific impairment approaches for these assets (no bright-line presumptions on the basis of changes in fair value, for example).
13. What is the accounting treatment for sales with a right of return?

Some sales grant a right of return to customers, such as a right to cancel the sale within a certain period. Under the second exposure draft, the right of return is not a separate performance obligation (no change from the first exposure draft).

In this case, the entity shall:

- defer a portion of revenue and recognise a corresponding refund liability equivalent to the estimated value of the expected refunds; this shall be estimated in accordance with the principles for estimating variable consideration amounts (i.e. the “expected value” or “most likely amount”, depending on the circumstances – cf. question 6 in the November 2011 issue of Beyond the GAAP);
- periodically re-estimate this refund liability;
- recognise an asset for the right to recover goods in exchange for settling the liability (based on the former carrying amount of the goods, in line with the estimate made above, and taking into account any costs involved in recovering the products, such as additional expenses and potential decreases in the value of the goods).

14. What is the accounting treatment for sales involving warranties?

As a reminder, the first exposure draft proposed a distinction between two types of warranty:

- warranties that protect the customer against faults that arise after the product has been transferred to the customer; these warranties give rise to another performance obligation in addition to the performance obligation to provide the product specified in the contract;
- warranties that protect the customer against latent defects in the product (e.g. legal warranties): these warranties do not give rise to a separate performance obligation, but require the entity to assess whether it has met its original performance obligation (to provide the product specified in the contract).

The second exposure draft no longer makes this distinction, proposing instead that the accounting treatment should depend on whether or not the customer has the option of purchasing the item without the warranty. Thus, the draft standard states that:

- optional warranties should be accounted for as separate performance obligations: as a consequence, the entity shall defer the portion of revenue allocated to the warranty element of the contract. This is in line with the proposal in the first exposure draft;
other warranties (which are not sold separately, such as legal warranties) should be recognised in line with IAS 37 (i.e., on the basis of the cost of the warranty, rather than on the basis of the transaction price, as previously) unless an exception applies.

The entity shall thus recognise a warranty liability, as is the case currently, with a corresponding expense. This is a significant change from the first exposure draft, which proposed deferring a portion of revenue for legal warranties as well.

The second exposure draft additionally stipulates that an entity shall assess whether all or part of a non-optional warranty provides the customer with an additional service.

Thus, for example, if the warranty covers a very long period, it is likely that this warranty includes an additional service, beyond the basic guarantee that the product provided meets the contractual requirements specified at the beginning.

In this case, the additional service shall be accounted for as a separate performance obligation. If it is not possible to distinguish between the basic legal warranty and the part of the warranty which involves an additional service, the entire warranty shall be accounted for as a separate performance obligation.

15. What is the accounting treatment for sales with customer options for additional goods or services?

According to the second exposure draft, if the customer has the option of acquiring additional goods or services, this only gives rise to a separate performance obligation if it provides a material right to the customer that it would not have had without signing the contract. The customer is effectively paying in advance, so the revenue shall therefore be deferred until the additional goods or services have been transferred to the customer, or until the customer’s rights have expired.

This is in line with the proposals set out in the first exposure draft.

Customer award points, which permit customers to acquire an item free of charge or at a reduced price at a future time in exchange for a certain number of points, are an example of a sale with the option to acquire additional goods or services. In this case, the entity shall assess whether the discount awarded is larger than the discount typically awarded to this category of customers if the first sale had not taken place.

If the selling price of the option is not directly observable, the entity must estimate it. This estimate shall reflect the discount which the customer would obtain when exercising the option, and shall take account of:

- any discount which the customer could obtain without exercising the option; and
- the likelihood that the customer will exercise the option.

A practical simplification is permissible in cases such as contract renewals. Thus, if the additional goods or services are similar to the original goods or services, the entity may allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided (taking account of the likelihood of contract renewal) and the corresponding expected consideration. This means that the entity does not have to estimate the stand-alone selling price of the option.

16. What is the accounting treatment for customers’ unexercised rights (breakage)?

The second exposure draft includes additional guidance on applying the revenue recognition model in the event that a customer holds an option which provides it with a material right to acquire additional goods or services (cf. question 15), but the customer decides not to exercise all of its contractual rights (“breakage”).

The guidance does not significantly alter the proposals put forward in the first exposure draft for such situations.
In this case, the entity shall assess whether it is reasonably assured of being entitled to recognise a breakage amount as revenue (with a corresponding cancellation of the liability). To do this, it shall apply the rules on constraining the amount of revenue recognised at the contract level, as set out in paragraphs 81 to 83 of the new standard (cf. question 6 in the November 2011 issue of Beyond the GAAP).

If an entity is not reasonably assured of being entitled to a breakage amount (for example, because it does not have sufficient experience with similar transactions), the entity shall only recognise this amount as revenue when the likelihood of the customers exercising their options becomes remote.

17. What is the accounting treatment for non-refundable upfront fees?

In certain contracts, the service provider may charge a non-refundable upfront fee for the cost of setting up the contract (e.g., joining fees, initial fees, etc.).

If no goods or services are transferred to the client at the time of the upfront fee, no revenue is initially recognised. The upfront fee will be recognised in revenue over the period during which the entity expects to provide services (taking account of any renewal options).

If the non-refundable upfront fees do not constitute a separate performance obligation, they are not taken into account when measuring the progress of the contract in the case of an ongoing transfer of goods or services (the same applies to related initial costs).

The costs of setting up a contract only give rise to the recognition of an asset if they meet the capitalisation criteria for costs necessary to fulfil a contract (cf. question 9 in the November 2011 issue of Beyond the GAAP).

18. What is the accounting treatment for licences and rights of use?

The IASB and the FASB have rejected the accounting principles for licences and rights of use which they set out in the first exposure draft. The rules in the first exposure draft revolved around whether or not the licence was exclusive, and required revenue related to a licensing contract to be recognised at the beginning of the contract (sale point) in the event that the entity granted the customer:

- a non-exclusive licence; or
- an exclusive licence for the whole economic life of the intellectual property.

In contrast, revenue was to be recognised over the duration of the licensing contract in the event that the entity granted the client an exclusive licence for only part of the economic life of the intellectual property (similar to a lease transaction).

Most commentators said that it seemed counter-intuitive to have different revenue recognition frameworks depending on whether or not the licence was exclusive. This characteristic does not in fact affect the nature of the performance obligation which the entity must fulfil.

For the second exposure draft, the two Boards finally decided that revenue should be recognised as soon as the customer obtains control of the right to use the licence.

Thus, if a customer does not receive the access codes until after the start of the contract which confers the right to use the licence, the entity shall not recognise revenue until the access codes have been provided.

In the event that the contract comprises several performance obligations (this would apply, in our opinion, to the sale of the right to use a piece of software and the obligation to update this software over the licensing period), the vendor shall assess whether these constitute separate performance obligations or a single performance obligation which shall be recognised over time.
19. What is the accounting treatment for sales with a repurchase agreement?

Currently, these contracts are recognised as leases when it is probable that the customer will exercise the repurchase option:

- the difference between the selling price of the sold item and the agreed repurchase price is recognised on a straight-line basis as lease income over the duration of the contract;
- the item is retained on the asset side of the balance sheet and is amortised.

The second exposure draft retains the same accounting treatment as the first one for situations where the entity has an unconditional obligation (forward) or an unconditional right (call option) to repurchase the asset. In this case, the customer does not obtain control of the asset because it has a limited ability to decide on the use of the asset and to obtain substantially all of the remaining economic benefits from it. A contract of this kind shall be recognised:

- either as a lease in accordance with IAS 17, if the entity can repurchase the asset for an amount that is lower than the initial selling price of the asset (taking account of the time value of money);
- or as a financing arrangement, in all other cases (i.e. if the repurchase price is equal to or more than the original selling price of the asset):
  - the vendor shall continue to recognise the asset;
  - the vendor shall recognise a liability for the amount received from the buyer;
  - the vendor shall recognise the difference between the amount received from the customer and the amount to be paid to the customer as a financial expense.

  If the option expires without being exercised, the liability is derecognised and revenue is recognised.

However, the second exposure draft introduces new rules for situations where the entity has an unconditional obligation to repurchase the asset at the customer’s request (put option).

The first exposure draft held that the customer had obtained control of the asset in this situation, and the agreement should therefore be accounted for in the same way as a sale with right of return.

Thus, in accordance with IAS 17 – Leases, the entity shall recognise a “right of use” for the asset over a specific period (as the customer does not obtain substantial control of the asset), if the following criteria apply:

- the exercise price of the option is lower than the initial selling price; and
- the customer has a significant economic incentive to exercise the put option (for example, the repurchase price is much higher than the expected market value of the asset at the repurchase date).

If the customer does not have a significant economic incentive to exercise the option, the sale with repurchase clause shall be recognised in line with the rules set out in the second exposure draft on sales with a right of return (cf. question 13).

When the exercise price of the loan is more than the original selling price and higher than the expected market value (taking account of the time value of money), the contract is in effect a financial arrangement:

- the entity shall continue to recognise the asset; and
- the entity shall recognise a liability which should initially be measured at the amount of the original selling price of the asset.

  If the option expires without being exercised, the entity shall derecognise the liability and recognise revenue.

The accounting treatment is therefore similar for forwards, call options and put options.
20. What are the key points to remember?

The key points to remember are as follows (taking account of the changes which the IASB has made in the second exposure draft on recognition):

- The core principle underlying revenue recognition is as follows: revenue recognition must depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services;

- In practice, this principle can be broken down into 5 steps, as in the first exposure draft:
  1. Identify the contract with a customer to which the principles in the second exposure draft apply;
  2. Identify the separate performance obligations in the contract;
  3. Determine the transaction price of the contract;
  4. Allocate the transaction price to the separate performance obligations;
  5. Recognise revenue when (or as) the entity satisfies a performance obligation; that is, when the entity transfers control of the good or the service.

- It would no longer be necessary to break down a contract into sub-contracts (identifying the separate performance obligations is sufficient);

- Combining contracts would no longer be based on an analysis of price interdependence; if the contracts are with the same customer (or related parties), are entered into at or near the same time, and are (for example) negotiated as a package with a single commercial objective, then they should be combined;

- Contract modifications would no longer necessarily be all recognised retrospectively: the catch-up method would only be applicable in the situation where a single performance obligation is partially satisfied at the date of modification (i.e. the remaining goods / services are identical to the goods / services already provided);

- A contract would be broken down into fewer performance obligations, given the new definition in the second exposure draft (no mention is made of any entity other than the vendor, and the concept of a distinct profit margin has been eliminated). In particular, a bundle of goods or services which are highly interrelated, which involve a significant service on the part of the vendor to integrate them into the combined item for which the customer has contracted, and which are significantly modified or customised to fulfil the contract, should be recognised as a single performance obligation;

- The customer’s credit risk would no longer be taken into account when measuring revenue. Impairment (or change in the measurement of an impairment) recognised in line with IAS 39 / IFRS 9 should be presented in a separate line of the statement of comprehensive income, adjacent to the line for revenue;

- When estimating variable consideration amounts, an entity should henceforth use either the “expected value” or the “most likely amount” method, as appropriate;

- The transaction price of the contract should take account of the time value of money in the case of deferred payment, but only in the event that the contract has a significant financing component and that the expected length of time between the transfer of goods or services and the payment is greater than one year;

- The general principle for allocating the transaction price of the contract to the separate performance obligations has been retained (i.e. the transaction price of the contract shall be allocated to the separate performance obligations in proportion to their respective stand-alone selling prices) and the residual approach would now be permitted for estimating selling prices which are not directly observable (in cases where the selling price is highly variable or uncertain).
Two lists of criteria are now provided for determining the point at which revenue shall be recognised: one for situations where goods or services are transferred over time, and the other for situations where goods or services are transferred at a point in time. Revenue recognition over a period of time in long-term contracts should be easier than in application of the first exposure draft.

The amount recognised in revenue at a given date (i.e. for all the performance obligations satisfied for a given contract) should not be higher than the amount of variable consideration to which the entity is “reasonably assured to be entitled”;

If a contract comprises several performance obligations, each performance obligation should be assessed separately in order to determine whether or not it is onerous (as in the first exposure draft), but the scope of the onerous test would be limited. In addition, the Boards have provided further details on the costs to be taken into account;

If an entity expects to recover the incremental costs of obtaining a contract, it should recognise them as an asset (whereas the first exposure draft stipulated that these costs should always be recognised as expenses);

Considerably more disclosures would be required in the notes than is currently the case. This would also apply to interim periods.
**Events/publications**

Seminars on “Current developments in IFRS”

Throughout 2012 Mazars’ Doctrine team will lead a number of seminars on IFRSs.

These seminars, organised by Francis Lefèbvre Formation, will take place on 23 March, 22 June, 21 September and 7 December 2012.

Applications for registration should be sent to: Francis Lefèbvre Formation: www.ffl.fr or 01 44 01 39 99.

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**Frequently asked questions**

**IFRS**

- The nature of control in the case of a separate vehicle created as part of a PPP contract.
- Step acquisitions: presentation of earn-out payments and acquisition costs for consolidated securities in the cash flow statement.
- Assessing control under IFRS 10.
- What is the correct accounting treatment for withholding tax on dividends issued by a subsidiary?
- What is the correct accounting treatment for a lease/management contract?

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

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