Tentative Agenda Decisions – IFRIC Update March 2017

Dear Sue,

MAZARS is pleased to comment on the above IFRS Interpretations Committee tentative agenda decisions published in the June 2017 IFRIC Update.

With the exception of IAS 38 (Goods acquired from promotional activities), we have strong reservations on the tentative agenda decisions proposed by the Committee.

1. The agenda decision on IFRS 3 identifies two possible ways of applying the requirements of the standards, and both of them may lead in some instances to irrelevant outcomes. Therefore, without reducing diversity in practice, the agenda decision would make some entities change their current practice for a less relevant outcome.

2. Regarding the IAS 28 issue, the Committee changed its mind since the May 2013 agenda decision, and the current tentative decision would lead to increased costs and complexity for preparers by requiring significant restatements between the financial statements of the acquirer and those of the ultimate parent. Moreover, the tentative agenda decision includes a statement relating to “transactions with owners in their capacity as owners” which could be seen as establishing a principle of identifying – and separating – an embedded equity transaction in any transaction between entities under common control that is not made on terms equivalent to those that prevail in arm’s length transactions.

3. IFRS 15 has deleted IAS 11 guidance regarding the costs to consider in an onerous construction contract. We encourage the IFRS Interpretations Committee or the Board to undertake a project to provide a consistent guidance under IAS 37 on measuring provisions for onerous contracts with customers, tackling with the questions of both the costs and the expected benefits to take into account. In the meantime, the issue could be partially dealt with through an agenda decision, but we strongly disagree with the tentative decisions made by the Committee. We do not think that incremental costs is a reasonable reading of the requirements in paragraph 68 of IAS 37. On the contrary, we believe that the costs that relate directly to a contract as
described in IFRS 15 could be a relevant measure of the costs that the entity cannot avoid because it has the contract. We therefore do not understand the rationale for refusing that approach, which has the merit to rely on a consistency between the wording used in both IFRS 15 and IAS 37.

Our comments on the various tentative agenda decisions are detailed in the Appendices to this letter.

Should you have any questions regarding the above comments, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27) or Edouard Fossat (+33 1 49 97 65 92).

Yours faithfully

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Appendix 1

IFRS 3 Business Combinations—Acquisition of a group of assets that does not constitute a business (Agenda Paper 2)

We do not agree with the IFRS IC’s tentative agenda decision made in June 2017 regarding IFRS 3 Business Combinations—Acquisition of a group of assets that does not constitute a business.

While we agree that the two approaches of allocating the acquisition price to individual items within the group described in the tentative agenda decision can be considered as compliant with the existing IFRSs, we are concerned there may be situations where neither of them could correctly and reliably depict the economic substance of the acquisition transaction. Moreover, stating that 2 methods are compliant:

- Will not completely eliminate diversity in practice, two different readings of the standards being considered as acceptable;
- Will oblige entities that currently first assess the reasons for a discount in the transaction price and allocate the discount according to this assessment before applying IFRS 3.2(b), to change their practice and adopt one of the two methods described in the Tentative Agenda Decision, with an outcome that could be a less relevant representation of the underlying economics of the transaction.

If the IASB finalises its proposed amendment to the definition of a business in IFRS 3, the issue would be more widespread, as some transactions that are business combinations applying the existing definition are likely to become acquisitions of a group of assets applying the proposed definition. We therefore believe that this issue deserves to be added to the Board’s or the Interpretations Committee’s standards setting agenda.

We are convinced that there are situations where there are identifiable objective reasons for a discount in the transaction price compared to the sum of the individual fair values of the assets and liabilities acquired.

We agree with the following Committee’s observation in the Tentative Agenda Decision:
"The Committee observed that if an entity initially considers that there might be a difference between the transaction price for the group and the sum of the individual fair values of the identifiable assets and liabilities, the entity first reviews the procedures it has used to determine those individual fair values to assess whether such a difference truly exists before allocating the transaction price."

When assessing whether such a difference truly exists, the entity may identify the reasons for that difference, and may conclude that all or part of the discount relates to one of the identifiable assets acquired.

In those situations, applying Approach #1 or Approach #2 may lead to irrelevant outcomes.
Example of irrelevant outcome from application of Approach #1:

Suppose the acquisition (with a discount in the transaction price compared to the sum of the individual fair values of the acquired assets and liabilities) of a separate real-estate entity that does not constitute a business. The identifiable assets and liabilities are the following:

- An investment property that has been fully amortised for tax purposes;
- Some rental receivables;
- Cash and cash equivalents;
- A financial liability that is the unpaid balance of the borrowing raised by the entity for acquiring the investment property.

Under this fact pattern, the acquirer identifies that the discount relates in its entirety to the tax status of the investment property: no future tax deductions will be available since the asset has been already fully depreciated for tax purposes.

Applying Approach #1 to this fact pattern would lead to allocating the discount to all identified assets and liabilities according to IFRS 3.2(b), including cash and cash equivalents and the financial liability. We are convinced that, given this specific fact pattern, allocating the discount in its entirety to the investment property would better depict the economics of the transaction.

Example of irrelevant outcome from application of Approach #2:

Now suppose the acquisition (with a discount in the transaction price compared to the sum of the individual fair values of the acquired assets and liabilities) of a separate entity that does not constitute a business. The identifiable assets and liabilities are the following:

- An investment property, with no significant difference between its fair value and its tax base;
- Some rental receivables;
- A significant investment (5%) in a listed entity;
- Cash and cash equivalents;
- A financial liability that is the unpaid balance of the borrowing raised by the entity for acquiring the investment property and the investment in the listed entity.

When assessing whether the discount in the transaction price truly exists, the acquirer identifies that the discount relates to the holding in the listed entity, given its relative size compared to the depth of the market for the equity instruments of that listed entity.

Applying Approach #2 to this fact pattern would lead to:

1. Recognising the financial liability, the rental receivables, the cash and cash equivalents at their fair value;
2. Recognising the investment in the listed entity at its fair value according to IFRS 13 (i.e. using a Price x Quantity formula);
3. Allocating the residual amount of the transaction price, after deducting the individual fair values of the financial assets and the financial liability, to the investment property that is to be initially recognised at cost.

Approach #2 leads therefore to allocating the entire discount to the investment property, despite the acquirer’s assessment that the discount relates to the holding in the listed entity.
Mazars' preferred solution

The two examples above clearly demonstrate that there are some situations where applying either Approach #1 or #2 would lead to irrelevant outcomes. It would be the case whenever (a) a clear rationale exists for the discount in the transaction price, and (b) a reasonable allocation of that discount to some of the acquired assets and liabilities can be made based on the underlying economics of the acquisition.

We would therefore recommend the IFRS Interpretations Committee and the Board to consider introducing a guidance for allocating the transaction price consistent with the principles for allocating a discount to the performance obligations under IFRS 15: according to IFRS 15.81, a discount is allocated proportionately to all performance obligations unless there is observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract.

Other comments

Should the Interpretations Committee decide to finalize its agenda decision, we would like to point out that quoting IAS 40 as a standard that includes initial measurement requirements for particular assets may be misleading. Indeed, one may understand that under Approach #2, investment properties would be recognized at fair value at the same time as financial instruments, before allocating the residual of the transaction price proportionately to other assets and liabilities.
Since Approach #2 requires to first measure assets and liabilities initially measured at an amount other than cost, this first step will not apply to investment properties, which are initially measured at cost according to IAS 40.20, whatever the model chosen for subsequent measurement.
Appendix 2

IAS 28 Investments in Associates and Joint Ventures—Acquisition of an associate or joint venture from an entity under common control (Agenda Paper 8)

The Committee has concluded that “the requirements in paragraph 26 of IAS 28 on the procedures used in accounting for an interest in an associate or joint venture should not be used as a basis to apply paragraph 2(c) of IFRS 3 by analogy”.

While we can understand that an exception must be applied strictly, we are concerned that this might differ from what is seen in practice and might create some complexity for preparers. Applying the agenda decision would lead to a different carrying amount of the investment, and different values assigned to the underlying assets and liabilities, in the consolidated financial statements of the acquirer (based on the application of IAS 28 and IFRS 3 provisions by the acquirer at the date of transfer of the equity investment from the transferor under common control) compared to those in the consolidated financial statements of the ultimate parent (based on historical equity accounting). This would require significant restatements to pass from the consolidated financial statements of the acquirer to those of the parent company.

In May 2013, the Committee had considered the same issue and had concluded that “this lack of clarity (...) would be better considered within the context of broader projects”. At that time, the Committee had endorsed a status quo, and had not obliged preparers to record restatements between the two levels of consolidated financial statements.

We wonder why the Committee decided in 2017 to revise its position, and what additional guidance has been included in IAS 28 that explains this shift.

In addition, the Committee suggests that any off-market element in such a transaction should be accounted for separately, taking into account the fact that “the transaction includes a transaction with owners in their capacity as owners”. While we understand the rationale, we are concerned that the agenda decision as drafted seems to establish a principle of identifying—and separating—an embedded equity transaction in any transaction between entities under common control that is not made on terms equivalent to those that prevail in arm’s length transactions.

Neither IAS 28 nor IAS 16, IAS 38, IAS 2 – which are standards that may deal with the acquisition of assets from a seller under common control – include provisions for separating a “transaction with owner in its capacity of owner” component. On the contrary, IAS 24 only requires disclosures on transactions with related parties in order to enable users of the entity’s financial statements to understand the effect of related party transactions on its financial statements.

We therefore suggest removing the reference to “transactions with owners” from the agenda decision, considering that this issue deserves a comprehensive debate at Board level.
Appendix 3

IAS 37 Provisions, Contingent Liabilities and Contingent Assets—Costs considered in assessing whether a contract is onerous (Agenda Paper 4)

Before IFRS 15, entities were referring to IAS 11 for onerous construction contracts and IAS 37 for onerous contracts within the scope of IAS 18. The onerous test in IAS 11 was leading to recognize an immediate expense when it was probable that total “contract costs” would exceed total contract revenue. IAS 11 was giving a precise list of which costs were to be considered as contract costs. When an entity was involved in both types of contracts (i.e. construction contracts and other contracts), different approaches may have been retained in practice when assessing the types of costs to consider in order to assess whether a contract was onerous, because of the fact that IAS 37 was unclear on this topic. When entities only had contracts falling under IAS 18 and thus IAS 37, diversity in practice also existed among them since the requirements of IAS 37 were not interpreted the same way.

IFRS 15 now addresses all types of contracts with a customer. However, IFRS 15 does not provide specific guidance to identify when a contract is or becomes onerous (especially as the guidance in IAS 11 no longer exists). An entity shall refer to IAS 37 which now applies to all contracts, including contracts previously within the scope of IAS 11. The need for clarification of IAS 37 is thus all the greater today and the stakes are hence even higher than before.

For that reason, we welcome that the Committee discussed how an entity should understand and apply the requirements under IAS 37 on onerous contracts and especially on which costs should be taken into account in order to make the assessment. However, we disagree with the tentative agenda decision which identifies two possible ways of applying such requirements, i.e. either a “full costs” approach or an “incremental costs” approach.

Firstly, we wonder why the IFRS IC deems it relevant to exclude the “directly attributable costs” approach, according to which contract costs as contemplated under IFRS 15 paragraphs 95-97 would be considered in order to assess whether a contract is onerous.

We understand that the reasoning of the IFRS IC is merely to disregard that approach because IFRS 15 does not include any guidance regarding onerous contracts and refers systematically to IAS 37. We note that the wording used in paragraph 68 of IAS 37 (“The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it”) is very close to the wording used in paragraphs 95 to 97 of IFRS 15 (“costs incurred in fulfilling a contract”). Without any further clarification in IAS 37, we wonder how it can be said that a “directly attributable costs” approach in accordance with IFRS 15 is not possible and is not a reasonable reading of IAS 37.

We believe that this approach has the primary merit of relying on a principle of consistency of the meaning of the words used throughout IFRSs. The statement made by the Interpretations Committee that “costs incurred in fulfilling a contract” does not refer to the same reality depending on whether the term is contemplated within IFRS 15 or IAS 37 appears counterintuitive, even if that concept is not defined in the Glossary.

Secondly, regarding the “incremental costs” approach which is deemed reasonable by the IFRS IC, we question the link that is made between the concept of “unavoidable” costs and “incremental” costs. According to the Oxford dictionary, “unavoidable” means “not able to be avoided, prevented or ignored. Inevitable.”

We believe there are some costs beyond incremental costs which are however unavoidable if the
entity has to fulfil its obligations as stated in the contract. For instance, costs relating to tools and equipment used in fulfilling the contract are unavoidable though they may not be incremental. Another example of costs that may be deemed unavoidable in order to fulfil the contract without being incremental are direct labor costs when the contract is performed by an existing workforce (i.e. which is not dependent upon the existence of the contract only).

These illustrations demonstrate that the “incremental costs” approach does not take into account costs that are “unavoidable” – in the linguistic sense of the term – when determining whether a contract is onerous. We therefore support the “full costs” approach (and we consider the IFRS 15 approach as a relevant declination of it) as a reasonable reading of the requirements in paragraph 68 of IAS 37, and would exclude the “incremental costs” approach from the possible outcomes.

In order to avoid increasing divergence in practice due to a lack of clarity of the standard, we urge the IFRS IC to refer to the Board in order to determine the best way to solve the issue on a timely basis. A standard-setting project should not only include guidance on which costs to consider in assessing whether a contract is onerous, it should also include guidance on how to assess the economic benefits expected to be received under the contract. Indeed, this is another key question that needs to be answered as soon as possible.

Having said that, and should the Committee decide nevertheless to finalize its agenda decision, we think it would be better to illustrate the differences between the “full costs” and the “incremental costs” approaches using fixed assets depreciation costs or direct labour costs, rather than the allocation of overheads, which is not in our opinion the core issue.
Appendix 4

IAS 38 Intangible Assets—Goods acquired for promotional activities (Agenda Paper 3)

We agree with the proposed tentative agenda decision, which is consistent with the requirements of IAS 38.

We also agree with the wording of the agenda decision, but we think it could be helpful to specify that:

- the accounting treatment results from the assessment of the expected use of the purchased goods when they are acquired;
- if the entity acquires any of these goods for a purpose other than for advertising and promotional activities, the entity would apply the requirements of other applicable IFRS when accounting for these goods (as indicated by the staff in §22 of Agenda Paper 3).