

IFRS news

Revenue recognition exposure draft – ‘take two’

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The comment period for the November 2011 exposure draft (ED), ‘Revenue from contracts with customers’, ended in March 2012. Andrea Allocco from PwC’s Accounting Consulting Services Central Team looks at the responses.

Revenue

Preparers, users and auditors have again provided feedback to the IASB and FASB (the ‘boards’) on their project ‘Revenue from contracts with customers’, this time on the second ED. The volume of letters dropped significantly from those received on the 2010 ED. This could reflect the boards’ success in responding to many of the matters raised on the first ED.

The boards requested feedback on six areas, as well as general input about whether the proposed guidance was clear and operational. Many respondents did not restrict their comments to the six areas; as a result, some additional matters were identified that might warrant attention. Most respondents continue to support the boards’ efforts, but a number of concerns remain, including the accounting for onerous performance obligations, the extent of disclosures and transition.

The majority vote

The responses to some of the questions and other topics that attracted comment are explained in the table below.

Some industries have collaborated in crafting comment letters and providing other feedback to the boards. We will look in more detail at those industry views in our practical guide due to be released in the next month.

What’s next?

The boards are expected to begin redeliberations in June, and the final standard is expected in late 2012 or early 2013. The effective date will be no earlier than 2015 but is likely to be 2016 or beyond, given the timetable and practical challenges of implementation.

Management should consider evaluating the effect of the proposals, including any implications on processes and controls, at a high level sooner rather than later. There will continue to be opportunities to influence the redeliberations through the boards’ consultation. Management needs to understand the effect of the standard on its accounting for contracts if it is to provide valuable feedback and influence the debate.

Summary of responses to significant issues

Common themes	Summary of observations
<i>Performance obligations satisfied over time.</i> The boards provided criteria to determine when a performance obligation is satisfied over time.	Respondents support the additional guidance but asked for clarity about how to apply the guidance in practice. Some also disagree with how 'alternative use' is defined, highlighting the potential for unintended consequences.
<i>Presenting credit risk.</i> The proposals require the effects of credit risk to be presented in a line item adjacent to revenue unless the contract has a significant financing component.	Respondents generally disagree with the proposals and believe that credit risk should be presented as an expense. There are also concerns about the complexity that might result from presenting credit risk arising from different types of contracts in different places on the income statement.
<i>Time value of money.</i> Management should reflect the time value of money if the contract has a significant financing component and covers a period greater than one year.	Respondents continue to express concern over the complexities and practical challenges of applying this guidance. Those who agree with the principle suggest the practical expedient be removed, as a one-year bright line is arbitrary.
<i>Variable consideration.</i> Variable consideration is only recognised when management has predictive experience of the consideration to which it is entitled (that is, the amount that is 'reasonably assured'). There is an exception for licences with sales-based royalties that states that they are never 'reasonably assured'.	Most respondents support the principle but want further clarity on how to apply the 'reasonably assured' constraint. Views are mixed on the sales-based royalty exception; some respondents are supportive but many oppose it – for example, those in the retail and consumer industry.
<i>Onerous performance obligations.</i> The proposals limit the onerous test to performance obligations that are satisfied over time and over one year.	The scope limitation did not change the general discontent with the onerous performance obligation test. Most suggest that existing guidance is used to determine when to record an 'onerous' contract provision.
<i>Annual disclosures.</i> The proposals continue to require extensive disclosures, including a reconciliation of contract balances and a maturity analysis of performance obligations.	Preparers and respondents have split views on this topic. Preparers have identified a number of disclosures that are not useful on the basis that they are not used to manage the business. Users support the proposals, citing that improvement to existing disclosures is crucial.
<i>Interim disclosures.</i> The ED proposes modifying IAS 34 to require many of the annual disclosure requirements in interim financial information.	Most argue that the amendments to IAS 34 are inconsistent with the principle that only significant changes from the last annual financial statements should be disclosed.
<i>Transition.</i> The ED requires retrospective application with the choice of certain reliefs.	Preparers remain concerned about whether retrospective application is cost-beneficial, despite the reliefs offered by the boards.

What's new for 2012 year ends?

Barry Johnson from PwC's Accounting Consulting Services in the UK looks at the new IFRS standards and interpretations that come into effect for 2012 year ends.



The IASB is working on a number of significant projects that are likely to affect 2015 year ends, but there are relatively few amendments to standards for 2012 and a number of small changes coming from the annual improvements process. Eight new and revised standards are not yet mandatory but can be early adopted.

Amendments mandatory for 2012 year ends

There are three amendments to standards that apply to December 2012 year ends. The amendment to IFRS 1, 'First time adoption', deals with an exemption for severe hyperinflation and removes some fixed dates noted in the standard. The amendment to IFRS 7, 'Financial instruments: Disclosures', introduces some additional disclosures that apply on the transfer of financial assets. The amendment to IAS 12, 'Income taxes', introduces an exception to the existing principle for the measurement of deferred tax assets or liabilities arising on investment property measured at fair value.

Amendment mandatory from 1 July 2012

An amendment to IAS 1, 'Presentation of financial statements', applies from 1 July 2012 and changes the disclosure of items presented in other comprehensive income.

Amendments mandatory for 2013 year-ends – early adoption possible

The revisions made to IAS 19, 'Employee benefits', are significant, will impact most entities and come into effect from 1 January 2013. The revisions change the recognition and measurement of defined benefit pensions expense and termination benefits and the disclosures required. In particular,

actuarial gains and losses can no longer be deferred using the corridor approach.

A group of five new and revised standards were published in May 2011, dealing with control and the scope of the reporting entity. IFRS 10, 'Consolidated financial statements', changes the definition of control; IFRS 11, 'Joint arrangements', reduces the types of joint arrangement to joint operations and joint ventures, and prohibits the use of proportional consolidation. IFRS 12, 'Disclosure of interests in other entities', brings together in one standard the disclosure requirements that apply to investments in subsidiaries, associates, joint ventures, structured entities and unconsolidated structured entities. As part of this overhaul of the consolidation standards, IAS 27 (revised) now deals only with separate financial statements, and IAS 28 (revised) covers equity accounting for joint ventures as well as associates. These new standards have to be implemented together and apply from 1 January 2013. They can be adopted with immediate effect (subject to EU endorsement for European entities) but only if they are all applied at the same time.

A number of current IFRSs require entities to measure or disclose the fair value of assets, liabilities or their own equity instruments. The fair value measurement requirements and the disclosures about fair value in those standards do not always articulate a clear measurement or disclosure objective. IFRS 13, 'Fair value measurement', published in May 2011, deals with this issue. The new requirements apply from 1 January 2013 but can be adopted with immediate effect (subject to EU endorsement for European entities).

Only one interpretation – IFRIC 20, ‘Stripping costs in the production phase of a surface mine’ – was published in 2011. It sets out the accounting for overburden waste removal costs in the production phase of a mine. It applies from 1 January 2013 but can be early adopted (subject to EU endorsement for European entities).

Amendment mandatory for 2015 year-ends – early adoption possible

IFRS 9, ‘Financial instruments’, was reissued in 2010 and includes guidance on the classification and measurement of

financial assets and financial liabilities and the derecognition of financial instruments. The standard is being added to as the IASB endorses different phases of the project to replace IAS 39. The reissued IFRS 9 applies to 2015 year ends but can be adopted with immediate effect (subject to EU endorsement for European entities).

For more detail of these requirements, see our practical guide ‘[New IFRSs for 2012](#)’; you can also find it under ‘IFRS updates’ on pwc.com/ifrs. Hard copies will be available after the improvements project is added.

IFRS quiz: hedging and embedded derivatives



The slogan of the financial instruments team within PwC’s Accounting Consulting Services network used to be ‘embedded derivatives are everywhere’. But spotting embedded derivatives is an art-form. This month, FI specialist Menno Hacken has split his IFRS quiz between embedded derivatives and hedging. Test your knowledge in two of the tougher areas of financial instruments in our IFRS version of ‘Where’s Wally/Waldo’. You might also want to read our topic summaries on [embedded derivatives](#) and [hedging](#) to improve your chances of a good score.

Embedded derivatives

Q1: What is an embedded derivative?

- (a) A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument.
- (b) A component of a hybrid instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the hybrid instrument vary in a way similar to a stand-alone derivative.
- (c) Both of the above.

Q2: Which of the following is a condition for an embedded derivative to be accounted for separately from the host contract?

- (a) When the economic characteristics and risks of the embedded derivative are not closely related to the economic

characteristics and risks of the host contract.

- (b) An embedded derivative is not accounted for separately. When a host contract contains an embedded derivative, the whole contract is measured at fair value.
- (c) Both answers are correct, as this is an accounting policy choice.

Q3: When should the assessment of the closely-related criterion be made?

- (a) When the contract is initially recognised – usually at the inception of the contract. This initial assessment is not revised, unless the contractual terms change.
- (b) On a continuous basis throughout the life of the contract, but only when market conditions change.
- (c) Both at inception of the contract and at each reporting date.

Q4: Lease contracts might include contingent rentals that are based on certain related sales of the lessee. Is such a contingent condition an embedded derivative?

- (a) It is an embedded derivative that is considered to be closely related to the lease host contract and is not accounted for separately.
- (b) It is an embedded derivative but is not considered to be closely related to the lease host contract and is therefore accounted for separately.
- (c) It is not an embedded derivative.

Q5: Entity A takes out a 5% fixed-rate loan with a bank for C1m. The loan is repayable in quarterly instalments. The debt contains

a pre-payment option that may be exercised by entity A on the first day of each quarter. The exercise price is the remaining principal amount outstanding on the debt plus a penalty of C100,000. Is this pre-payment option an embedded derivative, and if so, is it accounted for separately?

- (a) Yes, this is an embedded derivative. The pre-payment option is closely related; we therefore don't need to account for the prepayment option separately.
- (b) Yes, this is an embedded derivative. The pre-payment option is not closely related to the debt host contract and should therefore be accounted for separately.
- (c) No, a pre-payment option is not an embedded derivative.

Answers 1-5

Question 1: B – The variation of cash flows over the contract's term is a critical indicator of the presence of one or more embedded derivative. An example of a hybrid instrument is a loan that pays interest based on changes in the FTSE 100 index. The component of the contract that is to repay the principal amount is the host contract – this is the 'base state' with a pre-determined term and pre-determined cash flows. The component of the contract that is to pay interest based on changes in the FTSE 100 index is the embedded derivative – this component causes some or all of the cash flows of the host contract to change.

Question 2: A – Under IAS 39.11, an embedded derivative should be separated from the host contract and accounted for as a derivative if all of the following three conditions are met:

- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

- The hybrid instrument is not measured at fair value with changes in fair value recognised in profit or loss.

Question 3: A – This initial assessment is not revised unless the contractual terms change. This change must significantly modify the expected future cash flows associated with the embedded derivative, the host contract or both, relative to the previously expected cash flows on the contract.

Question 4: A – The contingent rentals based on related sales are considered to be closely related to the host lease contract, as the economic characteristics and risks are the same. The sales-related payments should not therefore be separated.

Question 5: B – The application guidance explains that these embedded derivatives are not closely related to the host debt contract unless the option's exercise price is approximately equal on each exercise date to the host debt instrument's amortised cost. [IAS 39 para AG 30(g)]. Given that the penalty payable is fixed, the option's exercise price (outstanding principal + penalty) will always exceed the debt's amortised cost at each option exercise date as the loan is paid off in instalments.

Hedging

Q6: Which of the following items are generally permitted to be hedging instruments under IAS 39?

- (a) Internal derivatives in the consolidated accounts, interest rate swaps and forward contracts.
- (b) Written options, interest rate swaps and forward contracts.
- (c) Purchased options, interest rate swaps and forward contracts.

Q7: Which of the following items are eligible hedged items under IAS 39?

- (a) A risk component of a financial item and a net position of financial assets and financial liabilities.
- (b) A risk component of a non-financial item and a net position of financial assets and financial liabilities.
- (c) A risk component of a financial item and a highly probable forecasted transaction.

Q8: When should hedge documentation be prepared?

- (a) Hedge documentation is not a requirement under IAS 39.
- (b) Hedge documentation should be prepared before the end of the reporting period in which the hedge is designated in a hedge relationship.

- (c) Hedge documentation should be prepared at inception of the hedge.

Q9: When should a cash flow hedge be discontinued?

- (a) When the hedging instrument expires or is sold, terminated or exercised.
- (b) When the hedge no longer meets the criteria for hedge accounting – such as, it fails effectiveness-testing.
- (c) Both of the above.

Q10: Which of the following statements is true?

- (a) The effective portion of a change in the fair value of a derivative is recognised in other comprehensive income in a fair value hedge and profit or loss in a cash flow hedge.
- (b) The effective portion of a change in the fair value of a derivative is recognised in profit or loss in a fair value hedge and other comprehensive income in a cash flow hedge.
- (c) The effective portion of a change in the fair value of a derivative is recognised in other comprehensive income in a fair value hedge and other comprehensive income in a cash flow hedge.

Answers 6-10

Question 6: C – Answer A is wrong because only instruments that involve a party external to the reporting entity can be designated as hedging instruments. It follows that internal derivative contracts between members of a group cannot be designated as a hedging instrument in the group's consolidated financial statements. However, internal derivative contracts may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group provided that they are external to the individual entity being reported on.

Answer B is wrong because a written option generally increases risk exposure because the potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. A written option does not therefore generally qualify as a hedging instrument.

Otherwise, IAS 39 does not restrict the circumstances in which a derivative may be designated as a hedging instrument (provided the hedge accounting conditions are met).

Question 7: C – Management cannot designate an overall net position as the hedged item. This is because hedging a common risk in portfolio of similar assets and liabilities would necessitate an allocation of the overall gain or loss on the hedging instrument to the individual items in the portfolio.

Question 8: C – Hedging under IAS 39 can only begin when documentation is put in place. This is designed to prevent abuse, as management needs to have a documented strategy in order to justify a modification from normal accounting.

Question 9: C – An entity should also discontinue cash flow hedge accounting when a forecasted transaction is no longer

highly probable or expected to occur, or when the entity revokes the designation.

Question 10: B – The effective portion of the gain or loss on the hedging instrument in a cash flow hedge should be recognised directly in other comprehensive income; the ineffective portion of the gain or loss on the hedging instrument should be recognised in profit or loss.

The gain or loss from re-measuring the derivative hedging instrument at fair value in a fair value hedge should be recognised in profit or loss; the gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognised in profit or loss.

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