IFRS news

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IASB and FASB release new revenue standard – a change in mindset?

The FASB and IASB have issued their long-awaited standard on revenue recognition, IFRS 15 Revenue from Contracts with Customers. The standard will affect most entities but how much will it actually change current practice?

The release of IFRS 15 is the culmination of a long running joint project between the IASB and the FASB to create a single revenue standard. The standard moves away from a revenue recognition model based on an 'earnings process' to an 'asset-liability' approach based on transfer of control.

Some argue that many of the changes from the original proposals mean that the outcome of applying IFRS 15 will not be that different from today. But one thing is for certain - application of IFRS 15 will require a change in mindset.

Why? Simply put – there is just more to think about. IFRS currently says very little about complex revenue transactions. There is limited or no guidance on, for example, multiple element arrangements, variable consideration and licences. Practice has developed and the IASB did not necessarily set out to change that practice. That said, preparers will now need to do more than simply think about 'commercial effect', 'fair value' and 'risk and rewards'.

IFRS 15 is effective from 1 January 2017 and early adoption is permitted. It seems far off but there is a lot to learn.

Key provisions

Let's look at the key provisions.

Performance obligations

Performance obligations are the building blocks in the new revenue recognition model. The amount and timing of revenue recognition are determined at the performance obligation level.

So what is a performance obligation? It is a promise to transfer either a good or a service (or a bundle of goods or services) that is distinct. IFRS 15 provides the criteria to determine when a good or service is distinct by focusing on how a customer might benefit from that good or service.

Transfer of control

The new standard is based on the principle that revenue is recognised when control of a good or service transfers to the customer. It replaces the separate models for goods, services and construction contracts under current IFRS. IFRS 15 is a single model that distinguishes between performance obligations satisfied at a point in time and those that are satisfied over time.

The criteria are provided to determine when a good or service transfers over time. For example, revenue from a traditional service would be recognised over time because the customer consumes the benefit (that is, the asset) as it is performed. But not all the criteria are intuitive and might change practice in some industries such as real estate and construction. If the criteria are not met, indicators of control are used to determine when revenue is recognised.

Variable consideration

An estimate of variable consideration is included in the transaction price only if it is highly probable that there will not be a significant revenue reversal. This principle is intended to provide useful information– that is, the IASB does not believe it is useful to recognise revenue that might be reversed in the future.

Indicators are provided to help management make this assessment. These include whether the variability is subject to factors outside the entity's influence, how long until the variability will be resolved, whether the entity has experience with similar types of contracts and whether there is a broad range of possible outcomes.

The 'minimum' amount that is not subject to significant reversal is recognised and updated each period. This means that some entities that previously deferred revenue until all contingencies were resolved might need to make an estimate and record revenue earlier. Others might find that the 'highly probable' threshold is not met and recognise revenue later than they do today.

There is one exception to this principle. Revenue for licences of intellectual property with a sales or usage based royalty is recognised only when sales or usage occurs.

One thing that might be surprising is how often entity's will have to look to the guidance on variable consideration. It captures everything that might change the transaction price including discounts, refunds, penalties and royalties. It does not, however, capture uncertainty about whether the customer will pay. Once a contract exists and revenue is recognised, any subsequent impairment of receivables is recognised in accordance with financial instruments guidance.

Licenses

IFRS 15 distinguishes between two types of licenses. The first is a 'right to use' IP (Intellectual Property) as it exists at the point in time the licence is granted, for example, rights to a film in its current form. A right to use is a performance obligation satisfied at a point in time. The second is a 'right to access' IP as it exists throughout the licence period, for example, access to a film library that is updated during the licence period. In this case, the performance obligation is satisfied over time. In either case, revenue is subject to the constraint for variable consideration.

Contract costs

Costs to obtain a contract (such as sales commissions) must be capitalised and amortised as revenue is recognised. This will be a change in practice for many who today expense these costs as incurred. As a practical expedient, costs may be expensed if the contract is less than one year. One challenge is that costs previously expensed might need to be capitalised at transition and then expensed in future periods.

For more information on these and other key provisions, see linked In Brief.

Convergence – will it last?

One of the IASB's primary objectives was to achieve consensus with the FASB and for the most part, it has been successful. That said, US GAAP preparers will likely have a different experience with implementation. Many will have to move away from industry guidance to a single principle based model for all transactions. Preparers may long for more guidance. So who will they ask?

The IASB and FASB have formed the Revenue Transition Resource Group to address these questions, at least in the short term. The Group includes representatives from both the US and international accounting worlds and including regulators, preparers and the audit firms. It will not issue authoritative guidance but watch this space – it is unlikely to get away without a written record of its discussions.

The Group will have a limited life. After that, issue resolution will likely revert back to the IFRS Interpretations Committee (IC) and Emerging issues Task Force in the US (EITF). This could get interesting. The EITF has historically been active in issuing guidance while the IC seems to be less inclined to address industry issues or specific transactions. So will convergence last? We will have to wait and see.

What is next?

The final standard is effective from 1 January 2017. For some, this new guidance will require change to systems, processes and controls. Management will need to assess implications as early as this year to ensure ample time to embrace the change and capture information needed for transition, especially those that elect the full retrospective adoption method.

Also get yourself prepared for the change in mind-set. Even if you do not expect a significant change, it is worth another look. At a minimum, the disclosures requirements will give you something to think about. Look out for more guidance by following the news on Inform.

IFRS 11 – how did we get here?

IFRS 11, Joint Arrangements is climbing to the top of the list of controversial standards for the IASB. Mary Dolson looks at recent discussions.

IFRS 11 has just passed its third birthday (issued in May 2011) and is now applicable across the IFRS world. EU IFRS preparers had a one year delay but are required to apply the standard for 2014. IFRS 11 may come to rival IFRS 1 as the most frequently amended standard and IFRS 2 for the most issues submitted to the IFRS Interpretation Committee (IC). One narrow scope amendment on measurement has been published and another is due in June (see more below). Both of these amendments will put further strain on the definition of 'what is a business' under IFRS 3.

Implementation issues continue to be submitted to the IC; the staff have a catalogue of issues on classification and measurement. The IC has published one agenda decision (rejection) on 'other facts and circumstances', is considering another on the same topic and has scheduled a further discussion on project entities in July (a further classification issue).

Why has IFRS generated this flurry of standard setting activity? Are there any clues in the development of the standard?

IFRS 11 was originally conceived as an easy win for the short term convergence programme. However, as work continued on the standard, the objectives evolved. The standard eventually published was described as establishing principles for the accounting for all joint arrangements. The policy choice for proportionate consolidation was eliminated; accounting treatment now follows classification. Joint ventures are accounted for under the equity method whereas the participants in a joint operation account for their assets, liabilities, revenue and expenses in accordance with other IFRSs.

The implementation challenges and questions were initially focused on classification, particularly when a joint arrangement in a legal entity might be a joint operation. Questions on the boundary between joint venture and joint operation continue to flow to the IC, particularly how to interpret 'other facts and circumstances'.

Measurement questions have also surfaced. IFRS 11 has very little measurement guidance, referring to IAS 28 for measurement of joint ventures and 'other applicable standards' for measurement of joint operations. Two narrow scope amendments have resulted, one published in May 2014 on acquisition of an interest in a joint operation, the other scheduled for June 2014 on accounting for the contribution of a business to a joint venture.

Published amendment – acquisition of an interest in a joint operation

The amendment requires an investor to apply the principles of business combination accounting when it acquires an interest in a joint operation that constitutes a 'business' (as defined in IFRS 3, Business combinations. Specifically, an investor will need to:

- measure identifiable assets and liabilities at fair value;
- expense acquisition-related costs;
- recognise deferred tax; and
- recognise the residual as goodwill.

All other principles of business combination accounting apply unless they conflict with IFRS 11.

The amendments are applicable to both the acquisition of the initial interest and a further interest in a joint operation. The previously held interest is not remeasured when the acquisition of an additional interest in the same joint operation with joint control maintained.

Pending amendment – contribution of a business to a joint venture

There is a further narrow scope amendment for joint arrangements that is expected to be published in June 2014. The amendment will eliminate the acknowledged conflict between IFRS 10 and IFRS 11. If an entity contributes a business to a joint venture, full gain recognition will be required, similar to the current treatment for the contribution of a business to an associate.

The IASB has also decided to clarify that only partial gain recognition is required on contribution of a subsidiary that is not a business (an asset in a corporate wrapper) to a joint venture or an associate. Drafting of this clarification has held up publication of the full gain recognition amendment.

Ongoing IC discussions

The IC has reported to the IASB on one of the more challenging issues; how to assess 'other facts and circumstances'. The IASB and IC seem to agree that the assessment should 'focus on whether the parties to the joint arrangement have rights and obligations that can be identified to be, in substance, direct rights to the assets and direct obligations for the liabilities of the joint arrangement'. The agenda decision gives us a few more words to consider. Some might assert that the agenda decision is narrower than the words in the standard. How this might impact practice is unclear as presumably most entities have already concluded on classification.

The IC also discussed accounting by a joint operation held in a separate vehicle. The IC has concluded they need to go back to the IASB in order to move the discussion forward. They still have a backlog of issues including classification and measurement.

What is next?

The narrow scope amendments while addressing practice issues continue to increase the pressure on the definition of 'business' and classification will undoubtedly continue to be a hot topic. Watch this space for the next instalment as the story continues to unfold.

Cannon Street Press

Amendments to IAS 38 and IAS 16 on revenue based amortisation

The IASB has amended IAS 16, Property, plant and equipment and IAS 38, Intangible assets to clarify when a method of depreciation or amortisation based on revenue may be appropriate. The amendment to IAS 16 clarifies that depreciation of an item of property, plant and equipment based on revenue generated by using the asset is not appropriate.

The amendment to IAS 38 establishes a rebuttable presumption that amortisation of an intangible asset based on revenue generated by using the asset is inappropriate. The presumption may only be rebutted in certain limited circumstances:

- where the intangible asset is expressed as a measure of revenue; or
- where it can be demonstrated that revenue and the consumption of the economic benefits of the intangible asset are highly correlated.

It is unlikely that the amendment to IAS 16 and IAS 38 will have a significant impact as few entities use a revenue-based approach to depreciation. However, entities with intangible assets related to service concession arrangements or intangible assets arising from programme rights in the entertainment and media industry might see a significant impact from the amendment.

Leasing redeliberations

The IASB and FASB ('the Boards') joint meeting focused on the definition of a lease in May. When determining if a contract contains a lease, an entity should assess whether: i) fulfilment of the contract depends on the use of an identified asset and ii) the contract conveys the right to control the use of the identified asset.

Identified asset

The Boards agreed that fulfilment depends on the use of an identified asset when the supplier has no practical ability to substitute an alternative asset or the supplier would not benefit from substituting. There was some concern about how a customer could assess whether the supplier can benefit from substitution. The Boards supported that if it is impractical to determine whether a supplier's right of substitution is substantive, the customer should assume that substitution rights are not substantive.

Right to control the use of an identified asset

The Boards agreed that this assessment should focus on the ability to affect the potential cash flows to be derived from use of the asset. The staff presented five examples on how to perform the analysis. The Boards' members expressed concerns about how the examples illustrate the concept. The IASB staff will likely work on the examples. The next steps by the FASB are unclear.

The IASB still has a number of topics to be discussed before issuing a final standard.

Conceptual Framework discussions

The IASB made significant progress on their discussion on the Conceptual Framework in May. The next due process step is an exposure draft which is expected at the end of this year. The discussions focused on the definitions of the elements, recognition and modifications to chapters 1 and 3 of the existing Framework.

The key tentative decisions were as follows:

- There was broad agreement to move forward with the definitions of assets and liabilities as proposed in the Discussion Paper. In particular, the notion that an inflow or outflow needs to be 'expected' will be removed from the existing definitions.

  The Framework should describe factors to consider when determining whether an asset or liability should be recognised rather than developing criteria.

- Chapter 1 should be amended to 'increase the prominence' of stewardship in the overall objective of financial reporting.
- 'Reliability' will not be reintroduced as an additional qualitative characteristic or an aspect of either relevance or faithful representation.
- The notion of prudence will be reintroduced, described as 'the exercise of caution when making judgments under conditions of uncertainty'.

IASB research project on equity accounting

The IASB discussed the project plan for further research into equity accounting. The project is in response to the 2011 Agenda Consultation in which some respondents expressed concerns or identified practice problems with equity accounting.

The objective of the research phase is to identify the issue and understand the needs of users before moving forward with further proposals.

The plan already identifies some possible alternatives to address the practice issues including:

- simplifying the equity method;
- retaining the current equity method as set out in IAS 28;
- fair value; and
- cost.

The next step is discussions with the Accounting Standards Advisory Forum next month.

IC takes on uncertain tax positions

The IFRS Interpretations Committee (IC) decided to move forward discussions on uncertain positions. The issue arose from a submission where the IC was asked to clarify the recognition threshold of an asset associated from an uncertain tax provision which might arise when a payment is made to the tax authority.

The submission questioned whether to apply a 'probable' threshold (IAS 12), or a 'virtually certain' threshold (IAS 37). The IC observed that IAS 12 provides adequate guidance on the topic, implying that a 'probable' threshold should be used. The IC, however, will add the issue to the agenda with an objective to clarify the guidance and reduce diversity in practice.

Know your IFRS 'ABC': Q is for 'Qualitative' disclosures for financial risk

Tina Farington from PwC's Accounting Consulting Services looks at best practice for qualitative disclosures about financial risks.

Many of us became accountants for a reason – we prefer numbers to words. So it is not surprising that qualitative disclosures are less popular with preparers of financial statements. Following the financial crisis, many blamed the accounting rules for the lack of sufficient warning. But disclosure of the financial risks of the entity, as required by IFRS 7, should have given some sign of what was to come.

Let's focus on the qualitative aspects of disclosure. IFRS 7 is a perfect opportunity for management to 'tell their story' about exposure to financial risks. But management can be reluctant to say more than the 'bare minimum' or reveal more than what their competitors might say. The regulators are starting to catch on. ESMA referenced IFRS 7 disclosures in their 2013 enforcement priorities emphasising the need to include better qualitative and quantitative disclosures about financial risks.

IFRS 7 in a nutshell

What is the objective of IFRS 7?

IFRS 7 applies to financial and non-financial institutions and is divided into two distinct sections. The first section covers quantitative disclosures about the numbers in the balance sheet and the income statement. The second focuses on risk disclosures which reflect the way management perceives measures and manages the risks.

It requires both qualitative and quantitative disclosures and explains that 'providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and form an overall picture of the nature and extent of risks arising from financial instruments.'

What has changed recently?

IFRS 7 has been amended several times over the years to improve disclosures about the entity's exposure to financial instruments. The latest two amendments relate to transfers of financial assets (applicable 1 July 2011) and offsetting financial assets and financial liabilities (applicable 1 January 2013).

Many of the fair value disclosure requirements previously included in IFRS 7 have been transferred to IFRS 13. But disclosures of all other types of financial risk remain in IFRS 7. These disclosures are more relevant now than ever as the financial markets become more complex and exposure to risk continues to increase.

What qualitative disclosures are required?

IFRS 7 focuses on risks associated with financial instruments such as credit risk (risk of suffering a loss related to a financial asset), liquidity risk (risk of not meeting financial obligations as they are due) and market risk (including currency, interest rate and price risk). For each type of risk, an entity should disclose:

- the exposures to risk and how they arise;
- objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- any changes to the above from the previous period.

IFRS 7 requires disclosure about the exposure to risks *and* how the entity has mitigated such risks. For example, an entity might disclose the policies around monitoring credit risk and investing in financial assets of a certain credit quality.

It might discuss the collateral enhancements to ensure collateral is sufficient to cover any loss. For liquidity risk, an entity should discuss the funds available to cover short and long term debt obligations. The entity might also economically hedge exposure to market risk even if it is not formally electing to apply hedge accounting. Qualitative disclosures should be included to comply with the spirit of IFRS 7.

Keep in mind there are more disclosure requirements about the entity's capital structure captured in IAS 1. This includes what an entity considers capital and its objectives, policies and processes for managing capital.

Frequently asked questions

Let's look at some common questions in practice around the application of IFRS 7:

Capital risk disclosures

Q: Are disclosures relating to 'externally imposed capital requirements' in IAS 1 only relevant for regulated entities?

A: The scope of 'externally imposed capital requirements' is broad and includes not only solvency ratios established by insurance or banking regulators, but also capital requirements/limits established by other bodies and through certain contractual relationships.

'Net' versus 'gross' risk

Q: An entity invests in a foreign currency bond maturing in one year and simultaneously enters into an FX forward contract with a corresponding maturity to offset the foreign currency risk. Is the materiality of the foreign currency risk on the bond assessed with or without the FX forward contract?

A: The materiality of the foreign currency risk on the bond is assessed without the FX forward contract. The bond and the FX forward are dissimilar items (per IAS 1), therefore the materiality assessment of the foreign currency risk is performed without considering the FX forward. If it is the risk that is material, the relevant qualitative disclosures are required.

The sensitivity analysis, however, is based on the net FX exposure, that is, after offsetting the foreign currency bond against the FX forward contract.

The same approach would apply for the assessment of credit risk, liquidity risk and other market risk.

Liquidity risk

Q: An entity has appropriately disclosed a liquidity table. What else is required?

A: The liquidity table provides helpful quantitative information but does not provide a full picture of how any entity manages liquidity risk. For example, it excludes information about how the maturity analysis links to funding requirements or how the entity manages borrowing against assets such as money market funds or unused facilities. ESMA[1] specifically encouraged issuers 'to make sufficiently clear and explicit the relationship between different disclosures related to liquidity risk and funding.'

Entities with more than one business

Q: How should an entity with two distinct operations (for example, a retail division and a bank division) present the risk disclosures if management monitors each division separately?

A: They should present the disclosures based on the management reporting separately for the bank and retail business, if that is the way management monitors the financial risks.

[1] ESMA European Securities and Markets Authority PUBLIC STATEMENT
European common enforcement priorities for 2013 financial statements
November 2013

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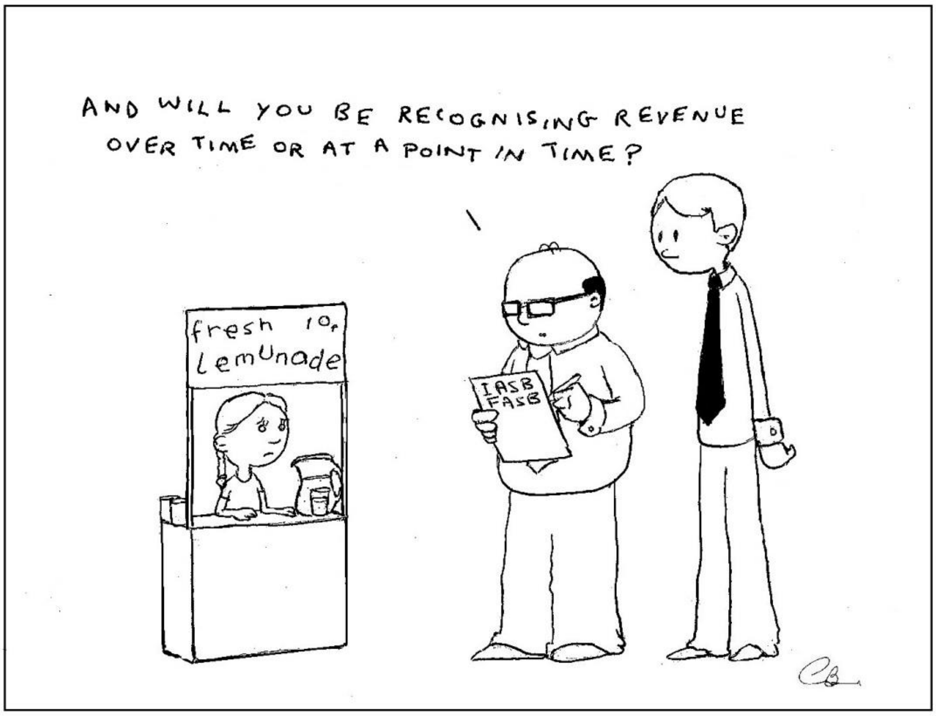

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