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IFRS news

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Convergence under pressure as IASB and FASB discuss potential revisions to revenue standard

The IASB and FASB were aligned on the need to address feedback on licences and performance obligations, but not the *how*. Dave Morgan, US ACS, looks at the deliberations.

Convergence between IFRS and US GAAP seems merely a blip in the history of standard setting. The joint revenue standard issued just under a year ago is under discussion again as the IASB and FASB look at implementation issues raised by stakeholders and discussed by the Transition Resource Group (TRG).

The boards discussed licences and performance obligations during their February joint board meetings. Both the IASB and FASB supported their own staff's recommendations, but the proposals were different. The IASB decided to simply clarify the principle related to licences, whereas the FASB agreed to amend it. The FASB intends to make other changes to the guidance on licenses and identifying performance obligations. The IASB will instead explore adding more examples and provide other education materials.

The boards did not discuss the ongoing outreach on the effective date. The FASB is expected to report on a potential extension to the 2017 effective date in Q2 2015. The IASB has not provided a specific timeline. The European Financial Reporting Advisory Group (EFRAG) board recently confirmed that it intends to endorse the new revenue standard with no change to the effective date.

Licence of intellectual property

The FASB and IASB discussed four implementation matters related to licences.

Nature of the promise

Stakeholders have asked how to determine when an entity's activities significantly affect the intellectual property (IP). In particular, which attribute of the IP (that is, form, functionality, value or all) should be assessed to determine whether revenue is recognised over time?

Two potential approaches were discussed. The first (Articulation A) clarifies that an entity should consider activities that significantly affect the utility of the IP. This would capture some, but not all, activities that affect the value of the IP. The second (Articulation B) focuses on the type of IP - either 'symbolic' IP recognised over time (for example, brand names) or 'functional' IP (for example, software) recognised at a point in time.

Both boards acknowledged a change to the standard is needed but the IASB supported Articulation A and the FASB Articulation B. Articulation B seems to create a brighter line, but could result in an outcome that is inconsistent with the existing principle and there will be some instances where the outcomes of the two articulations will differ.

Sales- and usage-based royalties

Stakeholders have asked how to apply the 'royalty exception', which prohibits revenue recognition until the related sales or usage occurs. Both boards agreed to make two clarifications:

- an entity is not required to split a royalty into a portion subject to the exception and a portion that is not, and;
- the royalty exception applies only when the predominant item to which the royalty relates is a licence, otherwise the general variable consideration guidance applies to the entire arrangement.

Other areas

The FASB decided to make two additional amendments to:

- highlight that, in some cases, an entity would need to consider the nature of a licence, even if it is not distinct from other goods or services in the contract, and;
- clarify that contractual restrictions of time, geography, or use are attributes of the licence and do not affect the number of promised goods or services.

The IASB decided that no standard setting is needed on the basis that stakeholders could consistently apply the guidance in both of these areas.

Performance obligations

The IASB and FASB discussed three matters related to performance obligations.

Promised goods or services

Some have questioned whether more promised goods or services will be identified as separate units of account under the new standard compared with current practice. In particular, the Basis for Conclusions states that an entity is not exempt from accounting for 'perfunctory or inconsequential' obligations. This has received attention from US GAAP preparers. Current US GAAP permits recognition of all revenue if the remaining obligations are inconsequential or perfunctory.

The IASB decided not to undertake any standard-setting at this time and indicated that it did not believe this was a concern for IFRS stakeholders. The FASB decided on an amendment that requires an entity to consider both quantitative and qualitative factors to determine whether a promise is immaterial in the context of the contract.

Distinct within the context of the contract

The new revenue standard requires entities to identify 'distinct' goods and services in a contract, which are accounted for as separate performance obligations. Distinct goods and services must be (1) capable of being distinct and (2) separately identifiable from other promises in the contract (that is, distinct in the context of the contract).

The IASB and FASB will look to develop examples to illustrate the application of the principle and clarify that a combined output can include multiple units or phases. The FASB also decided on changes to clarify the principle related to assessing whether the good or service is separately identifiable and align the factors to the clarified principle.

Shipping and handling services

Some US GAAP stakeholders have questioned whether shipping and handling services should be accounted for as a promised service or as a fulfilment cost. Responding to stakeholder feedback, the FASB decided to create a 'practical expedient' that provides entities with an option to account for shipping and handling as a fulfilment cost, rather than as a promised good or service, when shipping and handling occurs after control has transferred to the customer.

The IASB has not received similar questions from stakeholders. The board proposed further consultation with IFRS stakeholders to identify whether this is an issue.

What's next?

The IASB is expected to perform additional outreach on the amendments that were discussed during the meeting. Any proposed amendments would be subject to the IASB's due process. The FASB is expected to issue an exposure draft for public comment during the second quarter of 2015.

Investors call for clarity and conciseness in policy disclosures

Jen Sisson, Investor Engagement, looks at investors' views on accounting policy disclosures based on the latest survey.

PwC recently published the final part of our 2014 investment community research series. The survey is based on interviews of 85 investment professionals from around the world about their views on what they find useful, and where companies might improve. The focus was on accounting policies, the format of financial statements and the linkage between financial results and management commentary.

So what came out of this? Here is what I think are some good takeaways that management might want to action when planning the next annual report.

Action 1 – Combine policies with the notes

Combining your policies with related notes will make them more accessible and offer a clearer picture of performance. But whatever you do, make your accounting policies easy to find.

Some of the boldest innovations we have seen from companies are certainly popular, but there is also a significant contingent of investment professionals who told us they prefer a more traditional approach. For example, while some investment professionals would like to see accounting policies presented alongside the relevant notes, others prefer a more traditional 'all in Note 1' approach.

> "The location isn't important to me; it's about being able to see the important information easily."*
>
> "This is a really big opportunity to make financial statements easier to understand. Combining the policy with the relevant note means I am much more likely to pay attention to it."*

Whichever approach you take, making it easy for users of your accounts to find what they are looking for is critical.

Action 2 – Be clear about changes

Be clear about what has changed in your accounting policies, key judgements taken and choices you have made.

A clear challenge is balancing the level of detail required in an accounting policy note; the majority (58%) of investment professionals surveyed prefer a moderate amount of information. They want to see disclosures that include a description of significant accounting policy judgements and choices, and a brief summary of individual policies. Investment professionals also find it particularly useful when companies clearly disclose any changes to their accounting policies.

Action 3 – Be specific

Set your accounting policies in the context of your business and explain how the policy links to the specific nuances of your business model.

Many investment professionals have told us that accounting policies that simply repeat accounting standards are not useful; they want to see policies set in the context of your business, for example, explaining the revenue recognition policy in the context of different product lines or business units. Our latest research confirms this requirement.

> "Disclosure of new and significant accounting policies is a real potential area for improvement. It shouldn't just be boilerplate; I need a clear statement on how a new or significant standard will affect the business."*

Our survey is not the only place these messages are emerging. Accounting policies are under discussion by a number of stakeholders – so there is more to come.

* Investors and analysts talking to us as part of our survey 'Corporate performance: What do Investors want to know'

Cannon Street Press

ED on classification of liabilities

The IASB published an ED for a narrow scope amendment to IAS 1. The amendment seeks to clarify the principles for classifying liabilities as current or non-current. It proposes that classification should be based only on the entity's rights in place at the end of the reporting period and in particular, rights to 'roll over' a loan facility. The amendment also clarifies the term 'settlement' to include the 'transfer to the counterparty of cash, equity instruments, other asset and services'. The deadline for comments is 10 June 2015.

Leasing

The IASB continued it deliberations on the Leasing project. They discussed the following topics.

Transition

Lessees will apply the new guidance using a full retrospective approach or a modified retrospective approach. The modified retrospective approach will allow entities to avoid restating comparative information. Entities will recognise the cumulative effect of adoption as an adjustment to equity as at the date of initial application. The modified retrospective approach also permits a number of other reliefs including measuring assets and liabilities based on borrowing rates at the date of initial application and not restating the inclusion of initial direct costs.

Lessors will continue to apply existing accounting to any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease for which more specific requirements will be provided.

An entity will also have the option to grandfather the definition of a lease for all contracts that are ongoing at the date of initial application. This option must be applied consistently for all contracts.

Leases of Small Assets

The IASB will permit a recognition and measurement exemption for leases of small assets. It is expected that the basis for conclusions to the new standard will provide the quantitative threshold that the IASB had in mind whilst deliberating this exemption. That is, leases of small assets that have a rough value of US$5000 or less when new would not be required to be accounted for as leases but simply be treated as operating leases are today. Leased assets dependent on, or highly interrelated with, other leased assets would not qualify for the exemption.

Subleases Discount Rate

An intermediate lessor is permitted to use the same discount rate for the sublease that is used for the headlease if the sublease is a finance lease and the implicit rate cannot be readily determined.

The IASB still expects to issue a final standard in the second half of 2015. Due process, effective date and a number of sweep issues are still to be discussed. The IASB staff recently published a summary of their deliberations on the definition of a lease.

Feedback on rate regulation

The IASB heard a summary of the feedback received on their Discussion Paper (DP), 'Financial Effects of Rate Regulation. The feedback supported the IASB continuing with the project and that the project should lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements. The DP was seen as a good starting point for a description of the distinguishing features of rate regulation, but many recommended that the IASB should focus more on whether such features establish rights and obligations. The Rate-regulated Activities Consultative Group also held a meeting this week to discuss feedback from the DP and share views on specific topics to be considered by the IASB in the future.

Know your IFRS 'ABC': X is for 'eXiting from a business interest'

Elana du Plessis from PwC's Accounting Consulting Services South Africa recaps some key IFRS 5 principles

In today's uncertain economic climate, it is more common than ever to 'cut your losses' and walk away from a business interest. This could take many different forms, including sale of the whole or a part of the business, business rescue or liquidation, or abandoning or closing down a business.

The manner in which an investor exits a business could result in different outcomes from an accounting perspective.

The basics

Let's look first at whether an exit from a business interest would result in an interest being classified as held for sale or a discontinued operation (or both!).

Held for sale

To be classified as *held for sale* in IFRS 5, a non-current asset (or disposal group)'s carrying value should be recovered principally through sale rather than through continuing use. The asset (or disposal group) must be available for immediate sale in its present condition and the sale must be highly probable. Highly probable is a significantly higher hurdle than 'probable'. Luckily the standard does not leave this open for preparers to interpret. The standard provides some detailed guidance on what is meant by highly probable.

Assets (or disposal groups) classified as held for sale have certain measurement and presentation implications. They are measured at the lower of the carrying amount and fair value less costs to sell to the extent that they are within the measurement scope of IFRS 5 at the date of classification as held for sale and each subsequent reporting date. Assets are no longer depreciated or amortised from the point when the held for sale criteria is met. This reflects that the entity will not recover the asset through use.

Assets and liabilities of disposal groups held for sale are presented separately in the statement of financial position, without restatement of comparative information.

Loss of control

An entity that is committed to a sale plan involving the planned loss of control of a subsidiary should classify all the assets and liabilities of that subsidiary as held for sale, regardless of whether the entity retains a non-controlling interest in its former subsidiary after the sale.

Discontinued operation

Not all assets held for sale qualify to be presented as a discontinued operation. A component of an entity (or the whole entity) must be classified as held for sale or already have been disposed of *and* either represent a separate major line of business or geographical area, be part of a single coordinated plan to dispose of that component of the entity, or be a subsidiary acquired exclusively with a view to resale.

No remeasurements are required for discontinued operations, however the results and cash flows of discontinued operations are presented separately and restated in an entity's financial statements.

Not an asset held for sale?

When it is determined that the criteria to be classified as held for sale are not met, that asset (or disposal group) might still meet the criteria to be classified as a discontinued operation once it has been disposed of.

After disposal, the results and cash flows would be presented separately and the comparatives restated.

Practical issues

We have established that the 'exit event' is key to assessing the accounting implications.

Let's consider a simple example involving a seller who intends to exit from a business as a whole.

Example 1 – The investor intends to exit from the business

Joe's Fast Food decides to sell its entire controlling stake in Sue's Salads (its only South American subsidiary) to Victor's Veggies (a third party) in order to focus on its core business in North America.

Joe's Fast Food should classify all the assets and liabilities in Sue's Salads as held for sale from the date that the IFRS 5 criteria are met. This is the case even if a non-controlling interest is retained.

Because Sue's Salads is the only South American subsidiary (a separate major geographical area for Joe's) it would be a discontinued operation because it ticks two key boxes:

☑ held for sale and
☑ major geographical area.

At this point, the investor classifies all the assets and liabilities of that subsidiary as held for sale.

What if Joe's Fast Food did not decide to sell Sue's Salads, but closed down the operations instead?

The assets and liabilities of Sue's Salads would not be classified as held for sale because the carrying amount is not recovered principally through sale. Those operations could, however, be a discontinued operation once they are closed because they tick two other key boxes:

☑ the operations would be seen as having been disposed of and
☑ major geographical area.

The loss of control guidance does not apply in this case as Joe's Fast Food will have power over the relevant activities of Sue's Salads and be exposed to the variable returns thereof until the operations are ultimately closed down.

An exit event could also result from something that was not initiated by the investor, for example, business rescue procedures or another party exercising an option to acquire an interest in an entity.

Example 2 – External circumstances cause exit from the business

Joe's Fast Food owns a controlling 60% interest in Sam's Sandwiches. Joe's will not participate in a rights issue for shares in Sam's. In this particular case, Joe's Fast Food will lose control based on the principles of IFRS 10.

Does a loss of control equal a disposal?

The PwC view is that a deemed disposal planned to result in a loss of control of a subsidiary should be classified as held for sale if the other IFRS 5 criteria are met.

Watch this space

The IFRS Interpretations Committee (IC) is, however, currently considering whether there is a different view. They are looking at whether certain cases of planned loss of control of a subsidiary – dilution, modification of the shareholders' agreement and a call option held by a non-controlling shareholder – meet the IFRS 5 held for sale criteria. The IASB staff is also considering the broader question of whether the loss of control event on its own is key or whether an actual disposal also needs to occur.

The bit at the back.....

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