Luxembourg | IFRS Centre of Excellence newsletter

IFRS Centre of Excellence

1st Edition
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Welcome to this first 2016 edition of the IFRS Newsletter of Deloitte Luxembourg, which will update you on the latest IFRS developments.

IFRS Updates

Thinking forward to the preparation of your 2015 financial reporting for the period/year starting 1 January 2015, this Newsletter includes a reminder of the amended accounting standards that are now effective. Also, we will outline the amendments issued by the IASB around IFRS 10, IFRS 12 and IAS 28 which is of particular interest in Luxembourg considering the importance of investment entities and group accounting:

- IFRS 10, IAS 2(2011) dealing with the ‘Sale or contribution of assets between an investor and its joint venture or associate’ – to note the endorsement of this amendment was postponed and
- IFRS 10, IAS 28 IFRS 12’ Investment entities: Applying the consolidation exception

The complete list of standards and amendments which were issued, but not endorsed by the European Union, can be found on the EFRAG site: here.

Update on New Leases standard (IFRS 16)

Deliberations by International Accounting Standards Board (IASB) on the new accounting model for leases are completed and the final standard (that will replace IAS 17) has been issued. This newsletter highlights the principal effects this standard may have for entities, such as the requirement to bring leases onto the balance sheet.

Spotlight on application of IFRS 15, 'Revenue from contracts with customers'

The new revenue recognition standard issued in May 2014 introduces far more prescriptive guidance than was included in IAS 18, IAS 11 and the related interpretations. In July 2015, IASB has decided to defer the effective date of IFRS 15 to January 2018. We encourage you to perceive this delay as additional time to use for the analysis of the impact of the implementation of the standard, rather than delaying the assessment of the implementation.

In 2014 IASB and FASB have jointly set up a transition resource group for revenue recognition, the TRG. The aim is to share their views in stakeholder issues arising from the implementation of the new guidance, while the FASB and the IASB determine what action shall be taken consequently. A summary of discussed topics can be found on the IASB website, we will share the matters we found most relevant in this newsletter.

ESMA communications

End of October of 2015, the European Securities and Markets Authority has released several press releases covering the quality of information in the financial statements:

- Common enforcement priorities for 2015 financial statements
- Improvement of quality of disclosures in financial statements
- European common enforcement priorities for 2015 financial statements
- Improving Disclosures

In the light of most companies financial year end, we believe it is important to bear these enforcements in mind upon drafting financial statements. Even though directed at listed entities, we believe the communications indicate a best practice for all companies.

End of November 2015, ESMA published its 18th report, covering various topics, mostly on disclosures and use of judgement upon considering inputs for valuation and/ or impairment assessment analysis. We will focus in our newsletter on a short description of the latter.

In Deloitte Luxembourg, we have built up considerable experience in dealing with these practical issues. We are committed to providing continued leadership across IFRS key areas and helping institutions and companies to comply with IFRS requirements. For additional information on these topics and on services we could provide to your entity, contact us at luifrsdesk@deloitte.lu. Deloitte has a range of tools and publications to assist in implementing and reporting under IFRS.

We hope you find this issue useful. As always, we value and welcome your comments and feedback.

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IFRS Updates

Standards effective as from 1 January 2015

For the preparation of your 2015 financial reporting for the period/year started 1 January 2015 or thereafter, we remind you that the following amendment to accounting standards are now effective:

Amendments by the IASB on 21 November 2013 to IAS 19 "Employee Benefits" to clarify requirements for how contributions from employees or third parties related to service should be attributed to service periods (EU effective date 01 February 2015): here.

Amendments by the IASB on 12 December 2013, through the Annual improvements — 2010-2012 cycle (EU effective date 01 February 2015) and Annual improvements — 2011-2013 cycle, to:

- **IFRS 1** "First-time Adoption of International Financial Reporting Standards" to provide additional guidance on the meaning of "effective IFRSs"
- **IFRS 2** "Share-based Payment" to amend the definitions of vesting condition and market condition and add definitions for performance condition and service condition
- **IFRS 3** "Business Combinations" to provide additional guidance for accounting for contingent consideration in a business combination
- **IFRS 3** "Business Combinations" to clarify the scope of exception for joint ventures
- **IFRS 8** "Operating Segments" to provide clarification of the requirements for the aggregation of operating segments and the reconciliation of the total of the reportable segments' assets to the entity's assets
- **IFRS 13** "Fair Value Measurement" to clarify the scope of portfolio exception and to provide additional guidance for the measurement of short-term receivables and payables
- **IAS 16** "Property, Plant and Equipment" to provide additional guidance for the proportionate restatement of accumulated depreciation when the revaluation method is applied (EU effective date 01 January 2016)
- **IAS 24** "Related Party Disclosures" to provide additional guidance for the definition of key management personnel
- **IAS 38** "Intangible Assets" to provide additional guidance for the proportionate restatement of accumulated depreciation when the revaluation method is applied (EU effective date 01 January 2016)
- **IAS 40** "Investment Property" to provide clarification of the interrelationship of IFRS 3 and IAS 40 when classifying property as investment property or owner-occupied property

Amendments on IFRS 10 and IAS 28 and IFRS 12

For entities applying IFRSs as endorsed for use in the European Union, 2014 was the first year of mandatory application of the ‘package of five’ standards (including IFRS 10 Consolidated Financial statements, IFRS 11 Joint arrangements, IAS 28 (Revised) associates and Joint ventures and IAS 27 Revised Standalone financial statements and IFRS 12 Disclosure of interests in other entities). , whilst elsewhere in the world they will be applied for the third time. The pervasive nature of these standards and the level of judgement required in their application means they feature prominently on the list of priorities of regulators.

In 2014, IASB issued several amendments to these standards, of which two are not yet endorsed by the European Union:

- **Amendments to IFRS 10, IFRS 12 and IAS 28**: Investment Entities – Applying the Consolidation Exception (issued on 18 December 2014, EFRAG expects this amendment to be endorsed by the European Union in the second quarter of 2016)
- **Amendments to IFRS 10 and IAS 28**: Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (issued on 11 September 2014, endorsement postponed);
- **Amendments to IAS 27**: Equity Method in Separate Financial Statements (issued on 12 August 2014, EU effective date on 1 January 2016)
- **Amendments to IFRS 11**: Accounting for Acquisitions of Interests in Joint Operations (issued on 6 May 2014, EU effective date 1 January 2016);
- **Amendments to IFRS 10, IFRS 12 and IAS 27**: Investment Entities (EU effective date 1 January 2014) and
- **Amendments to IFRS 10, IFRS 11 and IFRS 12**: Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities - Transition Guidance (EU effective date 1 January 2014)

In particular, the endorsement process on the proposed amendment to IFRS 10 and IAS 28 'Sale or Contribution of Assets between an investor and its Associate or joint venture' has been postponed following identification of a conflict in the proposed amendment. This amendment is dealing with extent of the gain or loss recognition in a sale/contribution of a non-monetary asset involving an associate or a joint venture in exchange for an equity interest in that joint venture or associate. EFRAG recommended the European Union to postpone the endorsement process on IFRS 10 and IAS 28 until another project is completed regarding 'Elimination of gains and losses arising from transaction between an entity and its associate and joint venture'.

On 18 December 2014, IAS issued amendment to IFRS 10, IAS 28 IFRS 12' Investment entities: Applying the consolidation exception. IFRS 10 provides an exemption from preparing consolidated financial statements for a parent whose ultimate or intermediate parent prepares consolidated financial statements that are in accordance with IFRSs and publicly available. The amendments confirm that the exemption from preparing consolidated financial statements continues to be available to a parent that is a subsidiary of an investment entity event if the investment entity measures all its subsidiaries at fair value in accordance with IFRS 10. The exemption from applying equity method is also applicable to an investor in an associate or joint venture if that investor is a subsidiary of an investment entity.

IASB has clarified that the requirement for an investment entity to consolidate a subsidiary that provides services related to its investment activities applies only to subsidiaries that are not themselves investment entities. An investor may retain the fair value measurements that the associate or joint venture used for its subsidiaries in applying the equity method to an associate or a joint venture that is an investment entity.

Also, IASB clarified that an investment entity that measures all its subsidiaries at fair value should provide the disclosures required by IFRS 12 Disclosures of interest in other entities.

Update on New Leases standard (IFRS 16)

The International Accounting Standards Board (IASB) has published a new standard, IFRS 16 'Leases'. The concept of an operating lease for lessees would be eliminated, except for the short term leases, and therefore all leases would be recognized for the lessee's right to use the leased asset and obligation to pay rentals, respectively. In essence, for all leases, the IASB model requires a lessee to:

- Recognize lease assets and liabilities on the balance sheet initially measured at the present value of unavoidable lease payments
- Recognize amortization of the lease assets and interest on lease liability over the lease term and
- Separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities)

For lessees having currently material off balance sheet leases (operational leases), the most significant effect of the new Leases Standard will be an increase in lease assets and financial liabilities. Financial ratios deriving from assets and liability will therefore be changed (for example leverage or performance ratios). The lessees should consider the effect the new leasing model will have on existing debt covenants and whether performance metrics need to be modified. The carrying amount of lease assets could reduce more quickly than the carrying amount of lease liability, i.e. a similar effect if financing the purchase of an asset through a loan, which result on a decrease of the lessee's reported equity.

Also, the new standard would result in higher profit before interest (EBITDA) for lessees having currently material off balance sheet leases and consistently a reduction in operating cash outflows together with an increase in the financing cash outflows in the cash flow statements.

Thinking ahead, the entity may need to develop robust accounting policies due to the extent of judgement required around:

- Determination of the lease term at inception
- Application of exemptions, such as the portfolio exemption and the small leases exemption
- Separation of lease and non-lease components
- Treatment of extension options and/ or treatment in case of a reassessment of a lease term
- Treatment of lease term modifications
- Variable lease payments
- Discount rates used
- Treatment of sale and leaseback transactions

IFRS 16 'Leases' is for effective for annual reporting periods beginning on or after 1 January 2019, with early application permitted, if the entity is also applying IFRS 15 Revenue from contracts with customers.

More details can be found on the IAS Plus website: here.

Spotlight on application of IFRS 15, 'Revenue from contracts with customers'

As mentioned already in the introduction of this newsletter, the TRG has taken several comments from the industry over the new standard. The result of their meetings was that in around 50% cases no action would be taken by the IASB, while for a third discussions are pending or waiting resolution. For some of the queries (less than 10%), the IASB is considering to issue some practical expedient, technical correction or minor improvements, while for other topics the IASB is considering issuing an Exposure Draft.

Identifying performance obligations

The main topic addressed in the staff paper over identifying performance obligations is the clarification over what the expression 'Distinct within the context of the contract' means in the context of IFRS 15 para 27 ff. The discussion appeared following the potential diversity in defining what '*highly dependent on, or highly interrelated*' means for different stakeholders. There are two examples given, which are aimed at exemplifying the issue; for instance we can consider a contract under which not only a product, is sold, but also consumables (e.g. printer and a toner). Judgement over whether the obligation needs to be considered separately or joint in this case depends on the high dependency, interrelation and customization of the toners.

Principal versus agent considerations

This staff paper on Principal versus agent considerations specifically addresses three areas that users of the new standard raised as areas that would require additional clarification on:

- Unit of account – whether the assessment if the entity is acting in its quality as agent or principal should be made at contract level or at performance obligation level
- The fact that the indicators added in IFRS 15 under paragraph B37 are not to be considered as an additional or separate assessment that needs to be made by the entity is making over its capacity as agent or principal. The indicators do not override or replace the notion of control and are part of the initial assessment
- The control concept as opposed to the "old" risk based approach

As a reminder, following are the indicators comprised under paragraph B37, used to assess whether an entity is an agent (and therefore does not control the good or service before it is provided to a customer)*:*

(a) another party is primarily responsible for fulfilling the contract;
(b) the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;
(c) the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;
(d) the entity's consideration is in the form of a commission; and
(e) the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

There are several examples shared in the communication, which are comprised under a separate newsletter on the IASPlus website: here.

Licenses of intellectual property

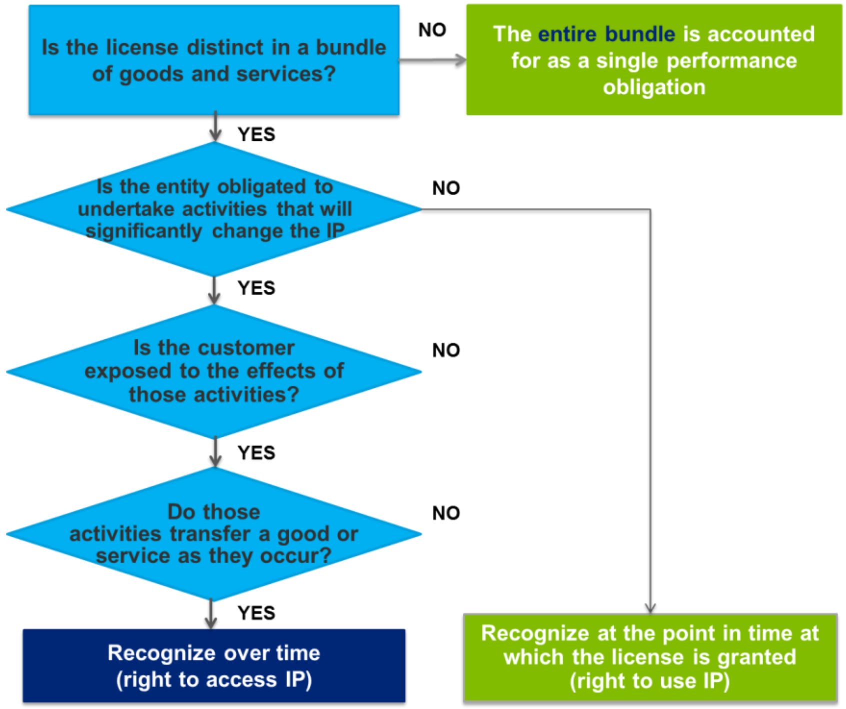
Certain aspects of accounting for licenses of intellectual property (IP) have made repeat appearances on the TRG's meeting agendas. Discussions at the TRG meetings have highlighted questions about the determination of the nature of an entity's promise in granting a licence (i.e. determining whether an entity's promise in granting a licence is a promise to provide a right to access the entity's intellectual property or a right to use the entity's intellectual property).

IFRS 15 requires an entity to assess the nature of a promised license over intellectual property, and specifically whether the license gives the customer the 'right to use' or right to access the entity's intellectual property. The board decided to emphasize that a company should consider the requirements related to identifying performance obligations before determining when a license transfers to a customer. That is because when a license is not distinct the company should recognize revenue when the bundle of goods or services (which includes the license) transfers to a customer. If a license is distinct, IFRS 15 specifies that timing of revenue recognition depends on whether the license provides the customer with a right to:

- **Access the company's intellectual property as it exists throughout the license period** (in which case the license transfers to the customer over time, hence the performance obligation is satisfied over time); or
- Use the company's intellectual property as it exists **at the point in time the license is granted** (in which case the license transfers at a point in time and hence revenue is recognized at that time).

The standard includes criteria to determine whether a license is a right to access the intellectual property. If these criteria are not met the license present a right to use an entity's intellectual property. The application of these criteria is critical in determining the manner in which revenue related to such license is recognized.

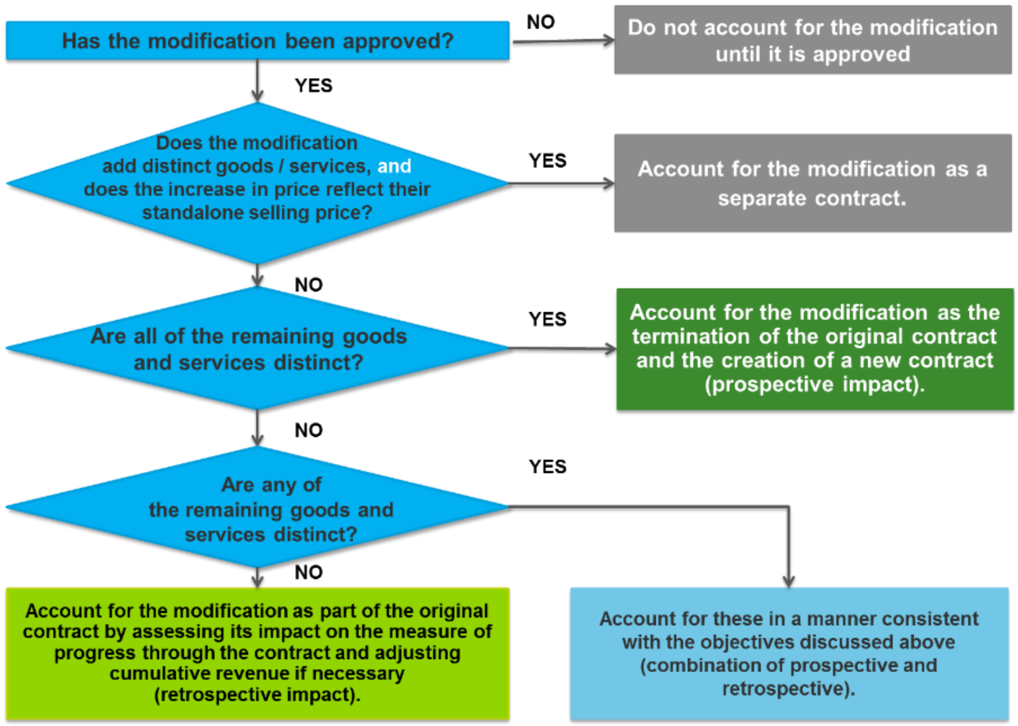
The flowchart below summarizes the approach.



Even though the approach can be summarized into a flowchart, the main challenges lie in the judgements underlying the decisions that are made at each step, as they may have considerable outcome as to the timing of revenue recognition.

Practical Expedients upon transition – contract modifications and completed contracts

Contract modification treatments can be displayed using a decision tree as follows:



The TRG has emphasized the need of the Standard users to receive additional guidance over the treatment of contract modifications. This is in context of:

- the multitude of contracts concerned by potential modifications (for example in the Telecom industry)
- the extent that a contract modification may cause – for instance, in the software, aerospace and defense industry.

The paper includes some practical examples, as well as a discussion over the CMAD ("Contract Modification Adjustment Date").

ESMA communications

Under its publication Common enforcement priorities for 2015 financial statements, the European Securities and Markets Authority (ESMA) emphasizes that the areas of focus will constitute:

- Impact of financial market conditions, more specifically the current interest rate environment, country risk and exposure of foreign exchange rates and high volatility for commodities
- Consistency of statement of cash flows to other primary financial statements
- Fair value measurement, especially disclosures related to non-financial assets and liabilities

These matters are described in detail under European common enforcement priorities for 2015 financial statements.

In its communication Improvement of quality of disclosures in financial statements, ESMA is stressing the importance of:

- including only relevant, material, specific, relevant, concise and clear disclosures, which need to be prepared in such a manner that disclosures are clearly focused on the relevant facts specific to the entity,
- avoiding boilerplate expressions, which can clutter the view of the reader

The above are detailed in the publication Improving Disclosures.

In its 18th report, ESMA has published extracts from its confidential database of enforcement decisions on financial statements, with the aim of strengthening supervisory convergence and providing issuers and users of financial statements with relevant information on the appropriate application of the International Financial Reporting Standards (IFRS).

The report contains ten matters analyzed, out of which the enforcer was in agreement with the issuer on two occasions. The main area of focus were disclosures, but also challenging judgements used by management in their assessment of fair values and impairment testing.

The first matter analyzed referred to assessing an intangible asset that was disposed of with no continuing involvement, except for receiving royalty income depending on the sales performance of the product licensed. The enforcer agreed in that particular set of circumstances that it is appropriate for the issuer to include this specific component under discontinued operations.

Secondly the enforcer analyzed disclosures in interim financial statements, more specifically whether it is appropriate to renounce duplicating significant information related to an impairment already published in the first quarter year interim financial statements in its interim (first half year) financial statements. The enforcer disagreed, referencing to IAS 34, paragraphs 6 and 15.

On the third topic, the enforcer focused on post-employment benefits, as accounted under IAS 19. The enforcer disagreed with the issuer's presentation of significant actuarial assumptions, as the issuer provided a range between highest and lowest assumptions, that was too wide.

Another matter arose from the application of IAS 34 and IAS 1 over going concern disclosures. The issuer understated the importance of such disclosures and provided an insufficient analysis of the issuer's financial situation, omitting among others a thorough analysis of the facts and circumstances presented.

A highly judgmental area is the assessment of control. The enforcer agreed with the issuer's assessment over control over an entity, over which it did not hold any equity interest, so that other facts and circumstances led to the assessment that the issuer has control.

On another matter over control, the enforcer disagreed with the issuer's assessment, which stated that the issuer had no control over the analyzed entity. The enforcer argued that the issuer in fact had the ability to direct the relevant activities unilaterally (emphasizing power, one of the elements of control, besides exposure to variable return and ability to affect return). We note that such disagreement has a pervasive impact over the accounts and therefore often should be considered with sufficient due care.

The enforcer found that the impairment of goodwill carried out by one issuer specifically contained a very optimistic forecast in terms of forecasted interest rates used for the calculation of the value in use of CGU's, and therefore the issuer concluded no impairment should be recorded. The enforcer indicated that the assumptions used in the issuer's calculation are not in line with requirements of IAS 36, which states that management shall base its cash flow projections based on reasonable and supportable assumptions, which represent management's best estimate of the range of economic conditions that will exist over the remaining useful like of an asset.

Another point on which the enforcer raised concern was the use of a discount rate to determine the fair value of a fixed-rate loan portfolio, since these should be calibrated to the market interest rates observable in the retail market (meaning the market for issuing new fixed-rate loans).

On another matter the enforcer addressed impairment testing, where the issuer had failed to consider all assets that generate or that are used to generate the CGU's relevant stream of cash inflows.

Last but not least, the enforcer analyzed the presentation and disclosure of discontinued operations in separate financial statements of an issuer that failed to apply the standard correctly for the comprehensive income arising from discontinued operations, which should have been presented separately.

Contacts

To find out more please feel free to contact any of the persons below.

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