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Q&A CNC 21/023	**QUESTIONS / ANSWERS:** **SALES SUBJECT TO A SUSPENSIVE CONDITION AND ESCROW OF A PORTION OF THE SALE PRICE: ACCOUNTING IMPLICATIONS FOR THE SELLER UNDER THE LUX GAAP AND LUX GAAP – FV REGIMES**

Context:

In the same way as the accounting directive 2013/34/EU[1], the LUX GAAP regime appears to be deficient as regards revenue recognition. The LUX GAAP regime merely sets out in Article 51 para. 1 point c) aa) LRCS, the principle of realisation as an application of the principle of prudence:

"Art. 51 (1) c) *measurement must be made on a prudent basis, and in particular:*
aa) only profits realised at the balance sheet date may be included;".

In accordance with this realisation principle, income is generally recognised when it is earned, i.e. when it is certain in principle.

At the same time, Article 51 para 1 point d) LRCS states that income is recognised in the financial year to which it relates, regardless of when it is received:

"Art. 51 (1) d) *account must be taken of income and charges relating to the financial year in respect of which the accounts are drawn up irrespective of the date of receipt or payment of such income or charges;"*

It must be inferred from this principle that income is generally recognised in the financial year to which it relates and that recognition cannot be unduly deferred simply because the income has not yet been received in cash by the undertaking.

Given the very general nature of these provisions, it is up to the administrative or management body of the undertaking to determine the accounting treatment of income in special cases not covered by the law, such as sales subject to a suspensive condition and sales giving rise to escrow of a portion of the sale price.

In the absence of legal provisions and given the specific nature of each contract, the purpose of this Q&A is to provide some food for thought to assist the administrative or management bodies in determining the accounting treatment of income in relation to sales subject to a suspensive condition (condition precedent) (point 1) and sales giving rise to escrow of a portion of the sale price (point 2).

An illustrative example is also provided in the appendix to this Q&A.

Questions:

This Q&A proposes to provide answers to the following questions:

1. Sales subject to a suspensive condition (condition precedent): what are the potential effects on revenue recognition?
2. Escrow of a portion of the sale price to guarantee the seller's commitments: what are the potential effects on revenue recognition?

[1] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

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Answers:

1. Sales subject to a suspensive condition (condition precedent): what are the potential effects on revenue recognition?

In practice, there are many situations in which sales are made subject to conditions, particularly conditions precedent. This is the case for transactions involving the disposal of participations that are concluded subject to approval or absence of objections by the competent authorities (e.g. competition authorities).This is also the case, for example, for cases involving the sale of a real estate property where the preliminary sale agreement – which generally records the parties' agreement on the property and the price[2] – is entered into subject to the condition precedent that the buyer obtains a mortgage loan.

In such cases, in accordance with the provisions of the Civil Code (art.1181[3] and 1182[4]), the sale is not effective and the proceeds cannot be recognised until the suspensive condition has been fulfilled.

Only if, in the opinion of the administrative or management body of the undertaking, the fulfilment of the condition is certain and the transaction is therefore not conditional may the proceeds from the sale be recognised before the condition is formally fulfilled.

This would be the case in particular where the administrative authorisation is merely a formality, with the undertaking certain to obtain approval as soon as it meets all the legal and regulatory requirements.

This would also be the case where the buyer is certain to obtain the mortgage loan, provided of course that the parties have not agreed to defer the transfer of ownership and of the risks relating to the property to a date later than that of the preliminary sale agreement[5]. In the latter case, the proceeds of the sale could only be recognised at that later date.

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2 As a result, the sale is complete within the meaning of article 1583 of the Civil Code.

Art. 1583 of the Civil Code:

"It is complete between the parties, and ownership is acquired by the buyer vis-à-vis the seller as soon as the item and the price have been agreed, even if the item has not yet been delivered or the price paid"

3 Art. 1181 of the Civil Code:

"An obligation entered into under a condition precedent is one that depends on either a future and uncertain event, or on an event that has already occurred but is not yet known to the parties.

In the first case, the obligation cannot be performed until after the event has occurred.

In the second case, the obligation takes effect on the day on which it was entered into"

4 Art. 1182 of the Civil Code:

"Where an obligation has been contracted subject to a condition precedent, the thing which forms the subject-matter of the agreement remains at the risk of the debtor, who has undertaken to deliver it only in the event of the occurrence of the condition.

If the thing has completely perished through no fault of the debtor, the obligation is extinguished.

If the thing has deteriorated through no fault of the debtor, the creditor has the choice either to dissolve the obligation or to demand the thing in its present condition, without any reduction in price.

If the thing has deteriorated through the fault of the debtor, the creditor has the right either to dissolve the obligation, or to demand the thing in the state in which it is, with damages".

5 For example, on the *closing date of* the transaction or on the date on which the notarised deed is signed.

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2. Escrow of a portion of the sale price to guarantee the seller's commitments: what are the potential effects on revenue recognition?

In practice, and often in the presence of conditions precedent, the sale of an asset may be completed for a given price [P], of which only a portion is paid to the seller [P - S], the remainder being placed in escrow [S]. In such cases, the question arises as to whether the amount corresponding to the escrow [S] should be taken into account in the seller's profit and loss account.

In this respect, it is important to note that escrow generally reflects a more or less significant uncertainty against which the buyer is trying to protect itself. This uncertainty does not call the transaction into question in principle but it is likely to influence the final sale price of the item that was the subject of the transaction.

In this context, it is the responsibility of the administrative or management body to analyse the conditions for releasing the escrow and to assess the degree of uncertainty associated with the release of the escrow. As long as the uncertainty remains and the degree of uncertainty appears significant, the income corresponding to the amount of the sale price placed in escrow cannot be recognised. Conversely, when the administrative or management body is of the opinion that the release of the escrow is granted in principle, the corresponding amount may be recognised as income prior to its cash collection (release).

Such a situation could arise, for example, in the event of the sale of a participation where the contractual clauses provide for the sale price to be revised downwards (e.g. by the amount of the escrow) if a condition is met (e.g. the occurrence of a dispute with the tax authorities or the departure of a key person) within a specified period. Depending on the assessment of the degree of uncertainty by the administrative or management body, it may or may not be appropriate to recognise the amount held in escrow as income.

An illustrative example is provided in the appendix to this Q&A.

Conclusion

In the silence of the law, CNC is of the opinion that it is up to the administrative or management bodies of undertakings to determine the accounting effects linked to the existence of a suspensive condition (condition precedent) and/or an escrow. In this context, the principle of prudence (art. 51 para 1 point c) LRCS) must be adequately taken into account as well as the objective of true and fair view (art. 26 para. 3 LRCS). Furthermore, it should be noted that article 65 para. 1 point 7*bis*°) LRCS requires a disclosure in the notes to the accounts of "*the nature and business purpose of the arrangements that are not included in the balance sheet and the financial impact on the undertaking of those arrangements, provided that the risks or benefits is necessary for assessing the financial position of the undertaking".*

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Illustrative example:

Undertaking ABC acquired a participation in undertaking 123 for EUR 60 million during the financial year N-1.

In accordance with the accounting policies of ABC, which prepares its annual accounts in accordance with the LUX GAAP regime, the shares in undertaking 123 are valued / measured at cost or at a lower value in the event of permanent (durable) impairment (art. 55 LRCS). Thus, at 31 December N-1 and 31 December N, the participating interest remained valued / measured in the balance sheet of undertaking ABC at its acquisition cost of EUR 60 million, the administrative body of undertaking ABC being of the opinion that the participating interest in undertaking 123 had appreciated significantly since its acquisition and that no impairment should be recognised.

On 30 September N+1, undertaking ABC entered into a sale agreement with the purchaser XYZ for its entire shareholding in undertaking 123. The sale was concluded for a total sale price of EUR 75 million [P], of which an amount of EUR 10 million [S] was placed in an escrow account to be released, where applicable, within 5 years[6]. The amount of EUR 65 million [P - S] was paid n cash on the day of the sale by the purchaser XYZ into the bank account of the seller ABC.

Under the terms of the agreement, the amount placed in escrow is intended to cover any tax disputes that may arise at the level of undertaking 123 after the date of its sale but which relate to earlier periods, i.e. to financial years N-1 and N which have not yet been assessed tax-wise as at the date of the sale. In this context, it is planned that the amount placed in escrow will be released when the tax assessments are issued, after deduction of the amount of any tax adjustment.

It is specified that the guarantee granted by the seller ABC to the buyer XYZ is capped at the amount of EUR 10 million placed in escrow, a tax assessment in excess of this amount being highly unlikely. It is also stated that the amount placed in escrow will be released no later than 30 September N+5, the date on which the seller's guarantee will expire.

Issues:

When preparing the annual accounts of undertaking ABC for the financial year ending 31 December N+1, for what amount should the capital gain on the disposal of its participation in undertaking 123 be recognised in view of the amount placed in escrow and of the related uncertainty?

Scenarios:

To answer the above question, three distinct scenarios have been identified:

- **Scenario 1**: the amount of EUR 10 million placed in escrow corresponds to the probable amount of the tax adjustment in relation to uncertain tax positions as identified in the acquisition audit carried out by undertaking XYZ on undertaking 123;

- **Scenario 2**: the amount of EUR 10 million placed in escrow is essentially intended to reassure the buyer in the knowledge that the tax situation of undertaking 123 is not problematic and that it is highly likely that taxation will be based on the amounts declared in the tax returns without any significant adjustment;

[6] It is up to the administrative or management body to determine whether the sale price should be discounted, taking into account the deferred payment associated with the escrow (payment deferred and not bearing interest). In this respect, it should be noted that under the LUX GAAP regime, the principle of "*monetary nominalism*" generally prevails (see Q&A CNC 20/021) and, as a result, amounts receivable are rarely discounted.

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- Scenario 3: the transferor undertaking ABC has identified and assessed the tax risk relating to the taxation of undertaking 123 for the financial years N-1 and N at a total amount of EUR 3.5 million. If the amount placed in escrow is almost 3 times higher than the tax risk, this is essentially to reassure the buyer XYZ, who is necessarily less well-informed than the transferor undertaking ABC about the nature and extent of the potential risks.

Proposals:

Depending on the scenario adopted, the amount of the capital gain to be recognised by ABC in its annual accounts for year N+1 will differ significantly, as set out below.

- **Amount of capital gain under scenario 1**:

Under scenario 1, the administrative body should calculate the capital gain by deducting the acquisition cost of EUR 60 million from the amount of the sale price that is certain, i.e. EUR 65 million (EUR 75 million less EUR 10 million), giving rise to a capital gain on disposal of EUR 5 million in respect of the financial year N+1[7].

Given that the tax risk has been assessed at EUR 10 million, corresponding to the amount placed in escrow, it would appear contrary to the principle of prudence and of realisation (Article 51(1)(c) LRCS) to take this amount into account in determining the capital gain on disposal for the financial year N+1.

In such cases, the capital gain on the sale and the method for calculating it, as well as the off-balance sheet rights and commitments associated with the transaction, must be disclosed in the notes to the accounts (art. 65 paragraph 1 points 7° and 7*bis*° LRCS).

- **Amount of capital gain under scenario 2**:

Under scenario 2, the administrative body would have to calculate the capital gain by deducting the acquisition cost of EUR 60 million from the virtually certain amount of the sale price, i.e. EUR 75 million, giving rise to a capital gain on disposal of EUR 15 million for the financial year N+1[8].

Considering that the amount in escrow is essentially a deferred payment intended to reassure the buyer but does not correspond to a probable or even a possible risk, it would appear contrary to the principle of matching income and expenses for the financial year (Article 51(1)(d) LRCS) not to take this amount into account in determining the capital gain on the disposal in financial year N+1.

In such cases, the capital gain on the sale and the method for calculating it, as well as the off-balance sheet rights and commitments associated with the transaction, must be disclosed in the notes to the accounts (art. 65 paragraph 1 points 7° and 7*bis*° LRCS).

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[7] Alternatively, it would appear possible to recognise a capital gain of EUR 15 million (i.e. EUR 75 million sale price less EUR 60 million purchase cost) and at the same time to recognise a value adjustment of EUR 10 million on the receivable corresponding to the amount of the sale price placed in escrow. It should be noted that if the presentation in the profit and loss account for financial year N+1 were to be modified, the net impact of the transaction on the result for financial year N+1 would be unchanged, i.e. a net credit of EUR 5 million (EUR 15 million of capital gain on disposal less EUR 10 million of value adjustment on the receivable). The carrying amount of the receivable should be reviewed at each successive balance sheet date.

[8] In this case, the capital gain corresponds to the difference between the sale price of EUR 75 million and the purchase cost of EUR 60 million. The amount placed in escrow appears in the balance sheet at the end of financial year N+1 under a receivable caption for a recoverable amount of EUR 10 million. The recoverability of this receivable should be reviewed at each successive balance sheet date until the amount placed in escrow is released in full or in part.

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- **Amount of capital gain under scenario 3**:

Under scenario 3, the administrative body would have to calculate the capital gain by deducting the acquisition cost of EUR 60 million from the virtually certain amount of the sale price, i.e. EUR 71.5 million (EUR 75 million less EUR 3.5 million), giving rise to a capital gain on disposal of EUR 11.5 million attributable to financial year N+1[9].

Given that the tax risk has been assessed at EUR 3.5 million, it would appear contrary to the principle of prudence and of realisation (Article 51(1)(c) LRCS) to take this amount into account in determining the capital gain on disposal for financial year N+1. Furthermore, considering that the excess amount of EUR 6.5 million placed in escrow (EUR 10 million less EUR 3.5 million) essentially constitutes a deferred payment intended to reassure the buyer but corresponding neither to a probable risk nor even to a possible risk, it would appear contrary to the principle of matching income and expenses (Article 51 para. 1 point d) LRCS) not to take this amount into account in determining the capital gain on disposal for the financial year N+1.

In such cases, the capital gain on disposal and the method for calculating it, as well as the off-balance sheet rights and commitments associated with the transaction, must be disclosed in the notes to the accounts (art. 65 paragraph 1 points of 7° and 7*bis*° LRCS).

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[9] Alternatively, it would be possible to recognise a capital gain of EUR 15 million (i.e. EUR 75 million sale price less EUR 60 million purchase cost) and at the same time recognise a value adjustment of EUR 3.5 million on the EUR 10 million receivable corresponding to the amount of the sale price placed in escrow. The receivable would then appear on the balance sheet at the end of financial year N+1 for a net amount of EUR 6.5 million (i.e. EUR 10 million less EUR 3.5 million). It should be noted that although the presentation in the profit and loss account for financial year N+1 would be modified, the net impact of the transaction on the net income or loss for financial year N+1 would be unchanged, i.e. a net credit amount of EUR 11.5 million (EUR 15 million capital gain on disposal less EUR 3.5 million value adjustment on receivable). The recoverability of this receivable should be reviewed at each successive balance sheet date until the amount placed in escrow is released in full or in part.