

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

THE FINNISH ACCOUNTING BOARD

FIN-FSA

THE CONFEDERATION OF FINNISH INDUSTRIES

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PANEL

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PROJECTS DISCUSSED

- *Revenue from Contracts with Customers*
- *Leases*

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Introduction

During the re-deliberations process, the IASB made some significant changes to its original proposals in relation to projects leading to the new IFRSs on revenue recognition and leases, in order to respond to comments received in public consultation. The objective of this event was to inform European constituents of, and obtain their feedback on, the direction taken by the IASB in its re-deliberations on these two projects. This event focused only on those issues that had caused major concerns at the exposure draft stage and had been subsequently re-deliberated.

The IASB and FASB have recently announced their decision to extend the convergence deadline for the projects beyond June 2011. EFRAG will meet with the IASB in June 2011 to discuss the feedback received during the outreach in Europe. In addition, the IASB is planning to release staff drafts of the final standards on these projects in summer 2011, provided they conclude that no re-exposure is needed. The EFRAG Chairman noted that EFRAG will consider issuing a comment letter on those documents.

Revenue Recognition

The EFRAG Chairman, who presented the session, noted that some constituents had argued for retaining the current standards on revenue recognition, as they saw no reason to modify them. She reminded that both projects (i.e., revenue recognition and leases) were on the convergence agenda with the FASB, and that having the U.S. converged to IFRS was in the interest of Europe.

However, bringing converged financial reporting requirements for revenue recognition is not the sole benefit to be expected. Two major issues that are currently a cause for concern (identification of the set of requirements that should apply, and allocation of the contract price to multiple elements) would be addressed by the new standard. As a result, the new standard is expected to bring an improvement to IFRS considered on its own.

Disaggregation of contracts

IASB tentative decision

In February 2011, the IASB tentatively decided that the revenue standard should clarify that the objective of identifying separate performance obligations is to depict the transfer of goods or services and also the profit margin that is attributable to those goods or services. The IASB tentatively decided on a one-step approach, requiring an entity to account for a bundle of promised goods or services as one performance obligation, if the entity provides a service of integrating those goods or services into a single item that the entity provides to the customer. If

goods or services are not linked by an integration service, an entity should account for them as a separate performance obligation if:

- the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
- the good or service is distinct.

A good or service is distinct if either:

- the entity regularly sells the good or service separately, or
- the customer can use the good or service either on its own or together with resources that are readily available to the customer.

The IASB's tentative decisions, in relation to disaggregation of contracts, were intended to address one of the concerns expressed by the construction industry. Participants had not formed a firm view on the new proposals, and indicated that they would have to analyse the final standard more closely, in order to assess how it would apply to specific circumstances. The discussion focused mainly on clarifying the proposals.

One participant asked if the new proposals would result in less separate obligations being recognised. EFRAG Chairman replied that, compared to the original proposals in the exposure draft, this was likely to be the case. However, it was difficult to compare it to the current practice, because IAS 18 *Revenue* does not contain comprehensive guidance on multiple-element arrangements.

One participant asked to clarify how the criterion, which requires a good or service to be sold separately on regular basis, would be applied in practice. The IASB project manager that participated in the meeting explained that entities would not be required to look at all other suppliers of a similar good or service; they would only have to consider their own business practice. It was also noted that the meaning of "regularly" should be clarified.

Participants have not yet formed a view as to whether the notion of "integration service" was operational. The IASB project manager noted that some constituents had asked how the supplier's ability to outsource different activities in the contract would affect the analysis of whether goods or services are linked by an integration service. Under the new proposals, even if some activities are outsourced, a contract would not be split if the supplier was responsible for the positive outcome of the overall contract.

One participant raised a question whether and how the tentative decisions in relation to disaggregation of contracts would impact the "free handset" issue raised by the

telecommunication industry. The IASB project manager noted that the IASB had discussed this issue with the telecommunication industry, and that there was a consensus that the delivery of a handset represented a separate performance obligation, as the handset could be used by the client on its own even if the client switched to another operator. The telecommunication industry did not oppose to the segmentation of contracts, but to the allocation of the contract price to the separable elements - the handset and the service subscription. They do not believe that revenue on the handset should be recognised in excess of the cash received, because of the uncertainty related to the subscriptions running for the initially agreed period. The IASB project manager also noted that the telecommunication industry representatives would make a presentation to the IASB at its meeting in May proposing some solutions.

Timing of revenue recognition

IASB tentative decision

In February 2011, the IASB tentatively decided that an entity satisfies a performance obligation continuously if at least one of the following two criteria is met:

- the entity's performance creates or enhances an asset that the customer controls as the asset is being created or enhanced (this criterion was included to deal with the concern of the construction industry); or
- the entity's performance does not create an asset with an alternative use to the entity and at least one of the following conditions is met:
 - the customer receives a benefit as the entity performs each task; or
 - another entity would not need to re-perform the task(s) performed to date if that other entity were to fulfil the remaining obligation to the customer; or
 - the entity has a right to payment for performance to date even if the customer could cancel the contract.

Some participants were not persuaded by the new criteria for revenue recognition, and suggested that the following two criteria should be met in all cases:

- the entity is entitled to receive a consideration;
- it is reasonably certain that the entity will complete the performance.

The IASB project manager noted that normally an entity would not perform if it did not earn a right to payment. She also noted that it was important to distinguish between the legal right to payment and an expectation to collect the amount from the customer, as these were two different notions. EFRAG Chairman asked the IASB project manager how much revenue the entity would recognise if the client could terminate a contract, in which the asset did not have an alternative use, without a cause and pay a penalty of 20% of the contractual consideration. The IASB project manager replied that it would not be the case, as under the new proposals when a good was produced, the supplier could only recognise revenue if the client controlled the work in progress. One participant noted that this was not clear, and it seemed that entities could recognise revenue also in other circumstances.

In relation to services, some participants raised concerns about the notion of “re-performance”. The IASB project manager explained that it was an indicator that the client had received some benefit, and therefore, the entity had transferred something. One participant asked if exposure to risks and rewards may be added as an indicator to evaluate the transfer of control in relation to services. The IASB project manager noted that the supplier is not exposed to the risks and rewards of the underlying goods when it only provides transportation services.

One participant suggested that the percentage of completion method should be applied to long-term contracts, and that the notion of “long term” should be linked to the entity’s business model. However, this view was not universally shared as other participants noted that they were applying percentage of completion method, to short-term contracts for services as well.

Non-contingent revenue and limitations on uncertain amounts

IASB tentative decision

In relation to non-contingent revenue, the IASB has identified the issue – and is considering what to do. It is uncertain what the outcome will be.

In relation to limitations on uncertain amounts, at its April 2011 meeting, the IASB tentatively decided that an entity should recognise revenue at the amount allocated to a satisfied performance obligation, unless the entity is not reasonably assured to be entitled to that amount. That would be the case in each of the following circumstances:

- the customer could avoid paying an additional amount of consideration without breaching the contract (e.g. a sales-based royalty);
- the entity has no experience with similar types of contracts (or no other persuasive evidence);

- the entity has experience, but that experience is not predictive of the outcome of the contract based on an evaluation of the factors proposed in the exposure draft (for example, susceptibility to factors outside the influence of the entity, the amount of time until the uncertainty is resolved, the extent of the entity's experience, and the number and variability of possible consideration amounts).

There was no specific comment on the issue.

Time value of money

IASB tentative decision

In March 2011, the IASB tentatively decided that an entity should adjust the promised amount of consideration to reflect the time value of money if the contract includes a financing component that is significant to that contract. In assessing whether a contract has a significant financing component, an entity should consider various factors, including:

- whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service;
- whether there is a significant timing difference between the date when the entity transfers the promised goods or services to the customer and the date when the customer pays for those goods or services; and
- whether the interest rate that is explicit or implicit within the contract is significant.

The IASB also tentatively decided that, as a practical expedient, an entity should not be required to assess whether a contract has a significant financing component if the period between payment by the customer and the transfer of the promised goods or services to the customer is one year or less.

One participant noted that the 'significant financing element' criterion involved a lot of judgment and could result in divergent applications. The IASB project manager noted that in this context 'significant' was something that a reader had to know to understand the transaction. Concerns were raised about the interaction of guidance with the application of the percentage of completion method.

Credit risk

IASB tentative decision

In March 2011, the IASB tentatively decided that an entity should not reflect the effects of a customer's credit risk in the measurement of the transaction price and, hence, revenue upon transfer of a good or service to the customer. Consequently, an entity would recognise revenue at the promised amount of consideration (i.e. at the stated contract price). An entity would be required to recognise an allowance for any expected impairment loss from contracts with customers. The corresponding amounts in profit or loss would be presented on the face of profit or loss statement as a separate line item adjacent to the revenue line item (as contra revenue), but not as an operating expense.

One participant noted that, under the Finnish GAAP, credit losses had to be recognised as an adjustment to revenue, meaning this requirement should not cause too much concern for Finnish preparers. Another participant asked if credit losses had to be recognised at inception. The answer was “yes”. It was also suggested that the IASB should ensure consistency between the decisions reached on credit losses in the revenue recognition and impairment projects.

Allocation of transaction price to separate performance obligations

IASB tentative decision

At its April 2011 meeting, the IASB tentatively decided that if the standalone selling price of a good or service underlying a separate performance obligation is highly variable, the most appropriate technique to estimate a standalone selling price may be a residual technique. Using a residual technique, an entity would determine a standalone selling price by reference to the total transaction price, less the standalone selling prices of other goods or services in the contract.

One participant noted that entities should be allowed to allocate consideration based on sales margins. The IASB project manager noted that this approach was rejected by the IASB at its meeting in April 2011.

Disclosures

Participants raised concerns that the disclosure requirements were extensive and that entities would need time to implement them. The IASB project manager noted that there was a general disclosure objective, and that not necessarily all disclosures would have to be made by each entity. One participant noted that the wording implied that the disclosure requirements were mandatory, and did not represent simple examples.

Final remarks

One participant raised a question about the expected timetable to finalise the standard. The IASB project manager replied that the IASB re-deliberations had advanced significantly, and that the staff draft of the final standard is planned to be available in July 2011.

One participant from Sweden noted that Swedish preparers were overall supportive of the principles in the standard; however, they had some concerns about their application in practice.

Leases

Overall, participants were not supportive of the direction taken by the IASB on this project. Almost all preferred retaining the current model in IAS 17 Leases, under which operating leases are not recognised. Participants generally agreed with the IASB that not all leases are financing transactions. Those few participants, who expressed a view, were evenly divided: some preferred the right of use model for all leases, and others favoured a model under which, for other-than-finance leases, the liability is measured at amortised cost and the total cost of the lease arrangement (comprising the interest charge and the amortisation of the right-of-use asset) is recognised on a straight-line basis over the lease term.

Definition of a lease

IASB tentative decision

During the re-deliberations, the IASB has tentatively decided that:

- An asset is a specified asset only when the supplier does not have substantive rights to replace it.
- Non-physically distinct portions of assets (i.e. portions of capacity) are not specified

asset.

- The right of control is transferred only when the client has the ability to direct the use of and obtain substantially all the benefits from the use of the underlying asset.
- If the asset is not separable from the provision of the services specified in the contract, the arrangement does not contain a lease. An asset is separable when any one of the following is met:
 - the customer can use the asset on its own or together with other resources readily available to the customer;
 - the asset is sold or leased separately by the supplier;
 - the right to use the asset and the services were negotiated separately between the supplier and customer.

One participant provided a few examples to clarify the application of the “specified asset” notion. EFRAG project manager noted that entities had to look at specific facts and circumstances, as the “specified asset” notion involved a certain amount of judgment. Discussion arose as to whether the “specified asset” notion would restrict the existing scope of the lease standard. The EFRAG Chairman said that, based on her understanding, it would, and the IASB member that participated in the meeting agreed. Copy machines, laptops, cars would not qualify as specified assets unless they were customised, or the supplier was denied the right to replace them.

One participant asked if a car would meet the notion of the “separable asset”. EFRAG project manager believed that it would, if the lessee could lease it separately. Another participant asked if a lessor and a lessee could arrive at different conclusions about the existence of a lease under the same contract. EFRAG project manager noted that both parties had to apply the same principles and criteria, but due to information asymmetry it was possible to have different conclusions.

Two types of leases

IASB tentative decision

The IASB has tentatively decided to differentiate between two types of leases: finance lease and other-than-finance lease. It also has tentatively decided that the criteria for distinguishing between these two types of leases would be based on the classification requirements for finance and operating leases in IAS 17 *Leases*. This tentative decision is subject to further

discussions by the IASB.

The IASB has tentatively decided that for other-than-finance leases, the impact on the profit or loss of the amortisation of the right-of-use and interest cost should be consistent with the result of the operating lease accounting in IAS 17.

Overall, participants supported the decision to distinguish between two types of leases. However, a number of participants raised concerns about the model proposed for other-than-finance leases, in particular:

- it introduced additional complexity;
- the pattern of amortisation of the right of use was inconsistent with the existing IFRSs;
- the pattern of amortisation should not be dependent on how the entity paid for the asset;
- existing accounting systems cannot manage this type of annuity-based depreciation;
- there would be impact on business reporting and tax implications.

Some participants also expressed concern about the application of impairment requirements to rights-of-use assets when these are amortised under an annuity depreciation method.

One participant noted that improved disclosures would provide the same amount of information as recognition. Conversely, a representative of a national security regulator noted that recognised amounts impact share prices more than disclosed amounts, and that disclosure does not allow determining the correct amount of the liability. Although some participants believed that some users are able to adjust the balance sheet based on disclosures.

Options

IASB tentative decision

The IASB has tentatively decided that amounts due under options that give a significant economic incentive to exercise should be included in the measurement of assets and liabilities. A significant economic incentive may exist because:

- the rental in the optional period is at favourable terms;
- the lessor offers some incentive in case the lessee exercises the options;

- the lessee has made significant investments in the leased asset (i.e. leasehold improvements) that would be lost if the option is not exercised.

Options to purchase and to extend (or terminate) a lease would be treated in the same way.

One participant noted that “significant” was likely to be applied in a subjective way. Another participant asked if management intention affected the assessment. It was clarified that it did not. Some argued that the decision of continuing to lease an asset was not affected by the amount of leasehold improvements made to that asset. Participants noted that the decisions had moved in the right direction, but that more work was required to avoid recognition of amounts that were not liabilities.

Contingent rent

IASB tentative decision

The IASB has tentatively decided that the following are included in the measurement:

- Rentals that are contingent on an index or rate;
- Contingent rentals that are in substance fixed minimum payments.

It has also tentatively decided that rentals that are contingent on an index or rate should be initially measured based on the spot rate.

Participants were overall supportive of the tentative decisions made by the IASB in the re-deliberations.

Short-term leases

IASB tentative decision

The IASB has tentatively decided that both lessors and lessees may elect as an accounting policy for a class of underlying asset not to recognise assets and liabilities arising out of short-term lease arrangements. In that case lessors and lessees would recognise lease payments in profit and loss on a straight-line basis over the lease term, unless another method is more representative of the pattern of consumption of benefits.

A short-term lease will be defined as a lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

Participants were overall supportive of the tentative decisions made by the IASB in the re-deliberations.

Other comments

Questions were asked about the timetable for completion of the project, the potential effective date, and whether the proposals would be re-exposed. The IASB member noted that they intended to complete discussions by the end of June 2011 and post a staff draft in July-August 2011. If the IASB reached a conclusion that the re-exposure would not be required, the final standard would be available by the end of the year with an effective date of 1 January 2015. If the proposals had to be re-exposed, it would take longer.