

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

ICAC

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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.

The EFRAG Chairman noted that this was the last European event, and that EFRAG had started to release feedback statements on prior meetings.

Executive summary

Participants, in general, did not oppose the proposals in relation to the Revenue Recognition. However, concern was expressed about the application of the disaggregation proposals to complex transactions.

Participants had concerns about the proposals in relation to the Leases project. Participants agreed that there are two different categories of leases, and that these should be accounted for differently. Participants were also concerned about the application of proposals on options.

Revenue Recognition

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.

One participant asked when an entity should split a software from the customisation of the software. The IASB member noted that the first step was to consider whether the supplier provided significant integration services – in other words, whether the supplier made significant changes to the goods provided. He admitted that this required a certain degree of judgment, but he had met with the representatives of the software development industry and was confident that the application would not prove too complex. The EFRAG Chairman noted that, in her view, in the scenario provided by the participant's question, the supplier was providing an integration service.

One participant noted that it was not correct to state that the entire construction industry was concerned about the proposals. The Spanish construction industry supported them, and believed that a construction contract could include several performance obligations. It was not too complex to identify them, especially if an entity was using output measures.

One participant noted that more guidance was needed in relation to the notion of integration service. The IASB member noted that the main point was to look at the client's ability to use the delivered goods separately. He invited participants to submit real-life cases to help the IASB staff in developing the appropriate guidance.

One participant asked whether it was relevant if the customer could use the good only with resources available from the same supplier. For instance, was a handset a separate component if the mobile had a sim lock built in? The IASB member noted that the entity should look at the contractual rights and obligations provided to the parties in the contract.

*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.

The EFRAG Chairman noted that under the proposals, an entity could, in certain circumstances, recognise revenue even if there was no right to consideration. This is different from IAS 18 *Revenue*, which includes a revenue recognition criterion requiring the inflows of economic benefits to be probable.

One participant provided an example, in which an entity supplied customised solutions developed on a common platform, and asked whether the supplier would be applying the percentage of completion method if it had a right to consideration in case of contract termination by the client. The benefit of the solution was available to the client only upon completion. As the scenario seemed quite complex, the EFRAG Chairman invited the participant to contact the EFRAG project manager in order to discuss it.

One participant from the audit profession was critical of the proposals, and noted that they would not allow revenue recognition in relation to audit services before the delivery of the audit report. The IASB member noted that the Board had not yet completed the discussion about professional services. Some members believed that if the service provider was entitled to payment in case of termination of the contract, it was appropriate to recognise revenue on the percentage of completion basis; others believed that the transfer occurred only at the end.

The IASB member noted that a number of telecommunication companies had presented an educational session to the IASB. All but one of them argued that free handsets had to be treated as a promotional expense. Conversely, a representative of one company argued that the delivery of the handset created a benefit for the client, so he believed that some revenue had to be allocated to it. It was a measurement issue, not a recognition issue.

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).

The IASB member noted that the Board had discussed uncertain amounts together with contingent rentals in Leases, and thought that the outcomes were consistent. He noted that many constituents were concerned about the recognition of uncertain amounts, but there was less concern about the revenue recognition based on estimated selling prices. He thought that these two issues were similar in the sense that both deal with issues that affect patterns of revenue recognition. The EFRAG TEG member noted that investors were more concerned with the overstatement of revenue, rather than the understatement of it.

Costs and benefits

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.

There was no specific comment on this issue. One participant asked if the IASB would amend IFRS 9 *Financial Instruments* to reflect the “one year or less” decision. The IASB member noted that they may need to consider the issue.

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.

There was no specific comment on this issue.

Other issues

One participant argued that asking for constituents' views on the separate issues was not the right approach. He may not have issues with a specific part of the Standard, but overall thought that the Standard did not result in useful information. Entities would end up preparing external accounts only for compliance purposes, with the real numbers reported internally; investors would have to adjust reported numbers to understand the real performance. The EFRAG Chairman invited the participant to contact EFRAG in order to discuss his concerns in more detail.

Leases

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; or
 - the right to use the asset and the services were negotiated separately between the supplier and customer.

The IASB project manager noted that “separability” did not derive from the existence of separate observable prices but from the client’s ability to use the asset separately.

One participant from the car lease industry asked about the supplier’s substantive right to replace the leased asset. In some of their contracts, they had a right to replace a car with another car, as long as it met certain requirements. Another participant provided an example of the rental of an area on an antenna site where the supplier was allowed to change the physical location of the antenna site as long as the performance did not change. Was that then a non-physical portion?

The IASB member noted that it was often useful to think whether the underlying asset could be bought or not. It was important to consider the extent of disruption that the replacement of the asset caused to the client. If the lessor was permitted to make replacements disruptive to a lessee's business, then the right might be substantive.

One participant noted that their lease contracts limit the use of assets in order to ensure that by the end of the lease term the assets are still in the working condition. He asked if this could be seen as a limitation of the right to control the asset by the client, which would indicate that the lease did not exist. The IASB project manager noted that the control must be assessed in relation to the right of use, not the underlying asset. In the example provided, the client still had the ability to control the right of use of the useable portion.

Two types of leases

IASB tentative decision

The IASB had tentatively decided to differentiate between two types of leases: finance lease and other-than-finance lease. The IASB had 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 *Leases*.

However, in May 2011 the IASB decided to revert to a single model because of conceptual and application concerns.

The IASB member explained that the IASB had listened to the concerns expressed by constituents and tried to find a solution. He had supported the annuity depreciation for some time, but realised that it was conceptually flawed. He thought that all long-term leases had a financing component; i.e., if an entity paid the full rental upfront, the price would be different. This is why the IASB decided to revert to the single model proposed in the exposure draft. The EFRAG TEG member noted that she agreed that the annuity depreciation did not work in the right-of-use model, but possibly because the model was not right. The EFRAG Chairman noted that this was a fundamental issue and asked participants two questions:

- Did participants believe that lease arrangements could be entered for two different purposes: financing an acquisition and obtain flexibility?
- If so, should there be two different accounting treatments?

Participants answered positively to both questions.

One participant from the lease industry agreed that the annuity depreciation was not the right answer. He thought that the Standard should scope out certain lease transactions. He did not think that entities entered into lease contracts for financing purposes, as cheaper alternatives can be found. He thought that the administrative impact on entities would be very disruptive, especially for small and medium entities.

The IASB member noted that regardless of the business purpose, there was a time value of money in every long-term arrangement. The EFRAG Chairman accepted this, but said that the IASB had to make a distinction to consider the different purposes of the transactions. The IASB project manager noted that one may argue that there were more than two categories of leases, as each transaction may have its distinct features, but this did not justify having different accounting models. She noted that the IASB had acknowledged that some users preferred to know the amount of the straight-line expenses. A disclosure requirement in that respect will be considered. The EFRAG TEG member noted that the liability may provide useful information about future cash flows, but the right-of-use asset was meaningless. She thought that the IASB should improve IAS 17, rather than changing the model.

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 should be assessed based on different economic factors. Changes in market rates after commencement of the lease should not be considered.

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

One participant noted that the proposals would result in the recognition of a lot of additional liabilities that did not make sense. An option was not a liability; entities should only recognise unavoidable payments. The EFRAG project manager noted that IAS 17 required recognition of optional periods when the exercise of the option was reasonably certain and asked whether the IASB expected that the new proposals would result in more frequent recognition. The threshold seemed still high. The IASB member noted that entities would start considering extensions only when they were approaching the end of the lease term, so it would be difficult to recognise an extension at inception. His personal view was that entities should recognise options only if they were favourable, and only when they were close to the end of the term; however, it was difficult to establish a rule.

The EFRAG TEG member was concerned that entities would avoid investing in leasehold improvements to evade recognising the optional periods.

One participant from the audit profession noted that there was concern about the proposals in the exposure draft because of the excessive cost; he was concerned that assessing a significant economic benefit increased the complexity. Also, the value of options may be volatile. The IASB project manager noted that the Board had acknowledged that, and that was why they had decided that changes in market rates after commencement date would not trigger reassessment.

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.

The IASB project manager clarified that sales-based rentals would be recognised only when incurred. There was no specific comment raised by participants.

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.

The IASB plans to re-discuss the exemption for short-term leases at a future meeting.

There was support for the IASB's re-deliberations on this issue.

Lessor accounting

Although the IASB has not re-deliberated on the lessor accounting, the current status of the discussion was illustrated to participants. It was clear that the IASB had moved away from the Performance Obligation approach. One participant from the lease industry noted that they supported a single derecognition approach with accretion of the residual asset. He noted that, under IAS 17 there were two alternative models for impairment, and asked whether the IASB would keep the option. The IASB member noted that they first had to agree on the accounting model, and then they would discuss impairment issues.

The IASB member noted that the FASB preferred the IAS 17 approach for lessors, but he did not think that it worked well with a right-of-use model for lessees. The EFRAG Chairman had concerns about the single derecognition model. The Board had acknowledged that in some leases the lessor was still exposed to risks and rewards. What was the basis for derecognition of the asset? The IASB project manager noted that under the model one had to consider the components, but the exposure to risks and rewards of the underlying asset did not drive the accounting. She noted that the FASB had accepted the approach for financial instruments, but some people still struggled when the underlying was a physical asset.

Other comments

One participant noted that it seemed that the IASB was reverting to a model similar to IAS 17 and questioned whether it was worth changing the Standard. The IASB member noted that there was a clear consensus, between standard setters, users and regulators that it was inappropriate to keep contractual liabilities off the balance sheet. They were open to discuss the features of the model, but lease liabilities should be recognised.

One participant asked if the IASB was thinking of SMEs, as the burden would be too high for them. The IASB member noted that they had not discussed this issue, but they could consider simplifying the model for SMEs.