EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

DASB

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PANEL

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PROJECTS DISCUSSED

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

DISCLAIMER

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 the direction taken by the IASB in its re-deliberations on these two projects, and obtain their feedback on it. 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.

Revenue Recognition

The discussion on the developments in the Revenue Recognition project focused on the developments related to:

- Disaggregation of contracts,
- Timing of revenue recognition,
- Costs and benefits.

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.

Overall, participants did not express their views on the tentative decisions, but used the opportunity to clarify the proposals.

One participant questioned the practical application of the proposed 'integration service' criterion.

Another participant noted that the requirements for disaggregation of contracts should be consistent between the revenue recognition and the insurance contracts projects, to the extent possible.

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.

Overall, participants did not express their views on the tentative decisions, but used the opportunity to clarify the proposals

Some participants raised the question of when the asset being constructed was controlled by the customer, and whether "turn-key" projects were controlled by the customer. The IASB project manager that participated in the meeting noted that "control" should be interpreted in a manner outlined in the exposure draft, and whether a "turn-key" project was controlled by the customer or not would depend on facts and circumstances.

Costs and benefits

Collectability

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.

The DASB Chairman noted that collectability was different from revenue, and therefore, the credit risk should not affect the revenue figure.

Other remarks

Allocation of transaction price

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.

The IASB also discussed whether an entity should be permitted or required to allocate a discount in the contract to the performance obligations in proportion to the individual profit margin on each separate performance obligation, if a relative selling price allocation results in a loss on one or more performance obligations. However, this was not tentatively agreed.

Overall, participants did not express their views on the tentative decisions, but used the opportunity to clarify the proposals

A DASB member suggested allocating the transaction price to performance obligations in proportion to margins, instead of stand-alone selling prices.

One participant raised a concern that allowing the residual technique could result in front-loading of the revenue. The IASB member that participated in the meeting noted that companies might be prevented from front-loading of the revenue by the onerous test (it will be a "back stopper"), i.e., if a high proportion of the revenue was allocated to the first performance obligation transferred to the customer, then the remaining part of the contract could become onerous. Therefore a loss would have to be recognised for the onerous contract provision.

Uncertain consideration and probability-weighted technique

IASB tentative decision

At its April 2011 meeting, the IASB tentatively decided that when the customer promises an amount of consideration that is uncertain:

- an entity's objective when determining the transaction price is to estimate the total amount of consideration to which the entity will be entitled under the contract; and
- to meet that objective, an entity should estimate either of the following amounts depending on which is most predictive of the amount of consideration to which the entity will be entitled:
  - the probability-weighted amount; or
  - the most likely amount.

The DASB Chairman thought that the standard should only specify the measurement objectives for the transaction price and not prescribe any techniques for calculating the amount.

Principle-based standard

A DASB member believed that the new proposals would result in a rules-based standard. The IASB member that participated in the meeting noted that constituents often argued for principle-based standards and at the same time requested more guidance.

What is revenue?

A DASB member highlighted the need for a thorough conceptual debate on why revenue is an important figure, what it should represent, and why it provides useful information. He also expressed his disappointment that such a debate had not taken place prior to developing the new revenue model. The IASB member that participated in the meeting explained that the IASB still thought it was a transfer concept.

Basel III

A participant asked whether the requirements in the new revenue recognition standard were aligned with the requirements in Basel III. The IASB member noted that the IASB had a constant dialog with Basel III. However, in relation to the standard on revenue recognition, there were no issues to consider.

Need for re-exposure

Some participants noted that the current direction taken by the IASB on the project notably deviates from the original proposals, and therefore preferred seeing the IASB re-exposing the draft.

Leases

The discussion on the developments in the Leases project focused on the developments related to:

- Definition of a lease,
- Two types of leases,
- Contingent payments and options,
- Scope,
- Short-term leases,
- Sale and leaseback transactions,
- The accounting models for lessors.

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 discussion focused on the question of what constituted a lease and what did not. The DASB Chairman concluded that there was no clear answer to that question. For example, it was unclear whether an agreement to rent a ship with a crew was a lease agreement or a service, because it would often be impossible to direct the use of the ship without the crew.

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 the views of participants on this issue varied.

The DASB Chairman expressed support for the new proposals, as he believed that they intended to provide a solution that could work in practice.

Some participants questioned the new proposals for two types of lessees noting that the objective of the project was to develop a single model, and to eliminate the distinction between two different types of leases. The IASB project manager that participated in the meeting noted that the new proposals were intended to address concerns about front-loading of expenses, which were expressed in relation to the proposals in the exposure draft. The IASB member that participated in the meeting also added that the IASB acknowledged that not all lease agreements were entered into for the purposes of financing. The IASB believed that these leases should be recognised on the balance sheet, but the impact on the profit or loss should be consistent with the result of the operating lease accounting under IAS 17. Additionally, the IASB member made it clear that continuing with the IAS 17 model was not an option, as the IASB believed that it was inappropriate to keep liabilities related to operating leases off the balance sheet.

A DASB member noted that the requirements for other-than-finance leases resulted in a strange amortisation pattern. The IASB project manager that participated in the meeting acknowledged that the amount, which was referred to as "amortisation in relation to other-than-finance leases", was not the amortisation as such, but a 'plug'. The IASB would consider what to do with this 'plug' and whether a different term should be used for it.

One participant asked whether the same 'plug'-accounting would be proposed for lessors. The IASB project manager replied that this issue had not been re-deliberated yet.

Another participant suggested the IASB to develop separate amortisation requirements for all leases. The IASB member explained that the IASB did not want to change accounting requirements for leases close to a loan and a purchase, i.e., finance leases. However, for leases that were closer to a service, the liability should be recognised, but the effect on the profit or loss should be similar to that of a service.

A participant noted that the model proposed for other-than-finance leases would result in higher asset values than under the straight-line amortisation method. The IASB project manager confirmed that, and noted that the issue would need to be considered further because the higher asset value could result in impairment. The DASB Chairman suggested that other-than-finance lease assets should not be assessed for impairment.

A DASB member raised a concern that the proposed measurement of an other-than-finance lease asset based on the income statement effect was contradicting the framework. He thought that income and expenses should reflect changes in the value of assets and liabilities, and not vice versa. Furthermore, the member was not convinced that all leases should be capitalised.

Contingent payments and options

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 also has tentatively decided that amounts due under options that give a significant economic incentive to exercise should be include 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.

Participants commented that:

- guidance was needed on what 'in substance fixed minimum payments' were;
- if a purchase option was expected to be used, the transaction should be accounted for as a sale; and
- lessor accounting should be considered.

In relation to the second issue, the IASB project manager replied that it followed from the proposals that in some cases, but not all, if a purchase option was expected to be used, the transaction should be accounted for as a sale. However, she highlighted that under the lease standard the right of use was considered rather than the underlying asset, and this influenced whether something had to be accounted for as a sale or not. On whether the similar requirements should apply to lessors, she thought that it would not be relevant if the current requirements of IAS 17 were maintained. In the case of finance leases, the current standard requires the entire asset to be derecognised, and in case of an operating lease, measurement of the asset would not be affected.

Scope

IASB tentative decision

The IASB had tentatively re-affirmed that entities would not be required to apply the Standard to leases of intangible assets.

The Board has added a scope exemption for arrangements in the scope of IFRIC 12 *Service Concession Arrangements*.

A participant suggested that if intangible assets were scoped out of the leases standard, the IASB had to clarify what intangible assets were as practice was not consistent.

Sale and leaseback transaction

IASB tentative decision

The IASB had tentatively decided that an entity should apply the control criteria described in the revenue recognition project to determine whether a sale occurred.

The IASB decided that the leases guidance would not prescribe a particular type of lessee accounting for entities that are accounting for the leaseback part of a sale and leaseback transaction.

The DASB Chairman did not think that it was necessary to include any requirements on sale and leaseback transactions in the standard.

The accounting model - lessors

IASB tentative decision

The IASB had not re-deliberated on the accounting model for lessors.

The IASB project manager informed the participants that the IASB was considering maintaining the requirements of IAS 17 for lessors, and adding disclosure requirements on the residual values. The IASB was unlikely to choose the performance obligation approach for lessors, as described in the exposure draft on leases. However, if the IASB would choose the performance obligation approach, it would likely only require the assets and liabilities to be presented on a net basis. Also the derecognition approach as explained in the exposure draft was considered for all leases. However, that approach requires a lessor to recognise a residual asset representing the rights in the underlying asset that the lessor retains, and it could be difficult to measure this right reliably for some leases.

One participant suggested that if a lessor had to recognise a residual asset, it should be allowed subsequently to adjust the value of that asset without having to recognise an impairment loss.

Another participant suggested that the lessor accounting should mirror the lessee accounting, otherwise the presentation of sub-lease arrangements in financial statements could be “awkward”.

A DASB member noted that the performance obligation model proposed in the exposure draft would not be consistent with the idea that an asset consists of multiple right-of-use units.

One participant expressed his support for the direction of the developments and asked whether accretion of the residual value under the de-recognition approach would be possible. The IASB project manager replied that this issue is subject to further discussions.

Other comments

New standard on leases

The DASB Chairman noted that the new proposals represented an improvement compared to the exposure draft; however, the result was still unsatisfactory. He questioned whether IAS 17 could be retained, or just improved.

The IASB member replied that it was not an option to retain IAS 17, as the IASB wanted all lease liabilities to be recognised by a lessee. For lessors, it was possible that IAS 17 requirements would be kept.

Convergence

It was discussed whether the IASB and FASB could agree on a final standard. The IASB member hoped that the two boards could agree on a common standard. She also thought that the changes in practice for the U.S. constituents would be greater than for the IASB constituents.

Effect on business

One participant asked whether the proposed requirements could stimulate entities to lease from a third party, rather than from a captive entity. The IASB project manager replied that this issue had not yet been considered, as the requirements for lessors had not been finalised.

Transition

One participant noted that the requirements on transition included in the exposure draft could lead to expenses being recognised twice under finance leases. The IASB project manager noted that they would consider the issue.

Need for re-exposure

Some participants noted that the current direction taken by the IASB on the project significantly deviated from the original proposals; therefore, they preferred seeing the IASB re-exposing the draft.

Next steps

The IASB member noted that a document will be made available for comments before the standard is finalised. The IASB had, however, not yet decided on whether the document would be an exposure draft or something else.