

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

CONFEDERATION OF DANISH INDUSTRY

**THE INSTITUTE OF STATE AUTHORISED PUBLIC
ACCOUNTANTS IN DENMARK (FSR)**

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PROJECTS DISCUSSED

- *Revenue from Contracts with Customers*
- *Leases*
- *Disclosure Framework (EFRAG proactive project)*

DISCLAIMER

This note has been prepared by EFRAG staff for the convenience of European constituents. The content of this note has not been subject to review or discussion by the EFRAG Technical Expert Group.

Introduction

During the re-deliberations process, the IASB made some significant changes to its original proposals in relation to projects leading to the new IFRS 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. Additionally, the IASB is planning to release staff drafts of the final standards on these projects in summer 2011, and the EFRAG Chairman noted that EFRAG will consider issuing a comment letter concerning those documents.

Revenue Recognition

While she presented the session, the EFRAG Chairman noted that some constituents had argued for retaining the current standards on revenue recognition, as they did not see reasons to modify them. She stressed 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.

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 EFRAG Chairman noted that this IASB decision had solved one of the concerns expressed by the building industry.

One participant asked if the IASB had considered collaboration agreements in the biotech industry. The IASB staff, who participated in the event, noted that they had several meetings with the representatives of the biotech industry since the development of the project's discussion paper. The main concerns expressed by pharmaceutical companies related primarily to accounting for revenue contingent on future sales, therefore the IASB staff had focused on this issue. The new guidance would require an entity to have predictive experience in order to account for revenue contingent on future sales. The participant raising the question, noted that this response addressed only part of his question.

One participant representing the building industry mentioned that the new proposals have been tested by them and that they were not expected to result in a significant change to the current practice, therefore they did not have concerns about the new proposals.

There were no remaining concerns raised by participants in relation to disaggregation of contracts.

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.

At first, the discussion focused on services and on the application of the notion of control to them. One participant noted the IASB has made a tentative decision to introduce a notion of re-performance in relation to obligations, which were satisfied continuously, because the notion of control did not work for services. The IASB staff noted that control was believed to be a good notion to depict a transfer, but that the IASB realised that it was difficult to apply to services. She reminded everyone that initially the principle for revenue recognition did not refer to the transfer of control, only the guidance did, therefore the principle has remained unchanged. The new criteria and conditions were intended to depict the transfer to the client. If a customer changes supplier and the new supplier would not be required to re-perform part of the obligation, this would prove that something has been transferred to the customer.

Some participants questioned whether, and how, revenue recognition was impacted by the existence of a right to consideration. For example, a company was shipping goods from Paris to New York, and they were stuck somewhere in between, should this company recognise revenue if the client would not be obliged to pay? Some participant suggested that revenue in such cases should be recognised only if the fulfilment of the obligation is highly probable. One participant suggested that revenue should not be recognised if the supplier bore the risk of loss. Another participant suggested that the existence of a right to consideration could be seen as evidence that the supplier had progressed in performing. The IASB staff noted that the objective of the project was to develop a principle for revenue recognition, but not to base revenue recognition on what would happen in a disaster scenario.

The EFRAG Chairman informed participants that EFRAG has tentatively raised the following issues in relation to the new proposals affecting the timing of revenue recognition:

- whether a right to consideration had to exist in order to recognise revenue; and
- whether the existence of an alternative use for the asset should impact revenue recognition.

It is important to note, that participants did not form views on this issue, which is central to the final standard, as they continue to think that the criteria for revenue recognition are unclear. There seemed to be a view that no revenue should be recognised unless the supplier had the right to receive payment (however, it may be in a more stringent manner than recommended by EFRAG). The participants did not express a view on whether percentage of completion method should be applied in circumstances other than those in which it is applied today.

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. This 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).

In responding to the proposals in the exposure draft, telecommunication companies were concerned that the proposals would result in revenue being recognised even when payment is contingent. For example, some telecommunication companies sell a two-year subscription to a customer, providing the customer with a handset. At present, in such situations, revenue is recognised as the customer is paying its monthly subscription fee. Under the proposals in the exposure draft, telecommunication companies would have to recognise revenue for the handset when it is delivered to the customer. Some telecommunication companies did not agree with the proposed approach, as they believed that the subscription service had

to be provided in order to create a right to receive a payment from the customer. Additionally, in some jurisdictions, customers are allowed to cancel the contract and keep the handset without “having paid for it” through the subscription.

Participants at the event were asked if industries other than the telecommunications industry were affected by this issue. One participant noted that pharmaceutical companies had a similar issue with development agreement and revenue contingent on reaching milestones. This concern, though, was alleviated as the IASB has tentatively decided to change proposals on measurement.

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.

Some participants raised a concern that credit losses should impact the revenue figure. They argued that trade receivables were financial assets, and thus their remeasurement should be classified as a financial charge in profit or loss statement. The IASB staff explained that in some industries sale prices reflected credit risk expectations – and users wanted to see the “real” sale figure. In general, participants did not agree that this was true for many other industries and suggested that such format of presentation is required only when the business model of the entity was to sell also to potentially bad customers.

Disclosures

IASB tentative decision

This topic has not yet been re-deliberated by the IASB.

In general, there was a strong sentiment that disclosure requirements proposed in the exposure draft were excessive and would not result in really useful information. Participants noted that disclosure requirements should be more industry-specific and should result in information that explains the business model of the entity. A “one-fit-

all” approach just created a lot of work for preparers to produce notes that users do not look at.

One participant suggested that there should be a requirement to disclose the type of commercial offers that an entity makes to its customers. Another participant noted that the proposed requirements would not be in line with an entity’s internal reporting, and this would be inconsistent with the approach to segment report in IFRS 8 *Operating Segments*. The representative of the Confederation of Danish Industry suggested that the IASB should ask users to specify what information that they could not do without.

Other issues

The following issues also were discussed at the event without specific comments or views being expressed by participants:

- Time value of money; and
- Allocation of transaction price.

Final remarks

One participant questioned whether a new standard on revenue recognition was really needed, if the proposals after the IASB’s re-deliberations looked very similar to IAS 18 *Revenue*, and whether the new standard would simply change only disclosure requirements. The participant also asked if the IASB considered re-exposing the proposals.

The IASB staff explained that the proposals, in relation to recognition and measurement of revenue, may not represent a major change to IAS 18, but they would represent a major change for the U.S. The IASB staff did not believe that the re-exposure of proposals was required, as the proposed principles had remained unchanged since the discussion paper, and changes related only to application of the principles. In addition, she questioned whether proposals had to be re-exposed if constituents believed that they would not result in major changes to the current practice in relation to recognition and measurement of revenue. Some participants held a different view on the re-exposure noting that the need for it should be assessed based on the amount of change made to original proposals in the exposure draft, rather than based on the resulting changes to IAS 18.

The EFRAG Chairman commented that the new standard on revenue was justified, because it addressed two major issues that currently cause concerns: it would result in one set of guidance for different type of arrangements (i.e., it would not be necessary to determine whether it was a good or a service before deciding how to account for revenue), and it would address multiple-element arrangements. She also agreed with the IASB staff that the re-exposure would not be needed if the practice would not change.

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

One participant asked whether a lease of an aircraft, with a crew and maintenance services (“wet lease”), would meet the definition of a lease under the new proposals. EFRAG staff that participated in the event responded that judgement would be required and that one would need to assess the degree of control exercised by the client in order to determine if the “specified asset” criterion was met.

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 had split views on this issue.

Some participants were quite critical of the model for other-than-finance leases and noted that they preferred the approach that was originally proposed in the exposure draft. Some participants raised concerns about the proposals in relation to amortisation of the right-of-use asset, noting that these proposals did not reflect the way in which the amortisation was reported internally, meaning companies would have to maintain two sets of accounts. Some participants acknowledged that if the IASB wanted to change IAS 17, they had to proceed with one model. Two models were confusing and difficult to implement.

Some participants suggested that recognition of leases on a balance sheet should be required only for the leases of assets that are used in revenue-generating activity (i.e., not all leases would be recognised), in order to link the recognition with the entity's business model. For example, an airline would capitalise leased aircrafts, but not company cars.

The EFRAG Chairman noted that EFRAG agreed that not all leases were a financing transaction and therefore tentatively supported the IASB's tentative decision. This view also was shared by some participants.

One participant noted that it was crucial to have a common approach for accounting on the lessee and on the lessor side.

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.

Overall, participants supported the direction of the IASB's re-deliberations on this issue, however, noted that there was still some work to do. Concerns were raised about some proposals that could result in recognising non-liabilities on a balance sheet, as they did not believe that it was appropriate. One participant suggested that the proposed criteria should only be indicators to guide the accounting.

One participant noted that it would not buy or extend a lease for an asset, which was not needed, only because the terms were favourable, therefore the participant disagreed that options should be included in measurement *only* because they were at favourable terms. Conversely, another participant noted that entities, in general, do not lease useless assets, therefore the new proposals seemed logical.

The EFRAG Chairman noted that the value of the option was in the flexibility. For example, some entities that started a new business entered in a medium-term lease with an option to extend, in order to see how the business developed in the first years without committing on a long-term basis.

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.

One participant questioned how “in substance fixed minimum payments” would be identified and whether payments that are 100% based on future sales would meet that criterion. EFRAG staff that participated in the event noted that the IASB had not finalised the discussions on the related indicators; however, some members had argued against treating fully variable payments as in substance fixed rentals.

Another participant noted that the new proposals were a practical relief, but conceptually arguable. The participant also argued that the new proposals were inconsistent with other standards that specify accounting for contingent consideration, for example, IFRS 3 *Business Combinations*. The EFRAG Chairman noted that this part of IFRS 3 was controversial, and that she did not believe that the lease guidance had to be consistent with it.

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.

One participant disagreed with the proposed definition of short-term leases. That participant suggested that the treatment of options should be consistent for measurement purposes and for the purposes of defining whether a lease is short-term, i.e. if a lease could be extended over 12 months, but the option not giving a clear economic advantage. Such lease should be considered as a short-term lease.

The representative of the Confederation of Danish Industry asked why the definition of the short-term lease was limited to 12 months, and whether it could be extended to 24 or 36 months. EFRAG staff noted that IFRS generally referred to short-term as 12 months.

Other comments

One participant raised concerns about the proposal to discount future payments for finance leases using the incremental borrowing rate, noting that it would conflict with the requirements of IAS 36 *Impairment of Assets* in relation to testing the right-of-use for impairment.

Preparers expressed concerns that it would be burdensome if many less significant non-core assets had to be recognised in the balance sheet. One preparer suggested distinguishing between what is classified as production costs (to be in the scope) versus other costs (to be out of the scope).

EFRAG proactive project Disclosure Framework

There was a general consensus that disclosures have grown out of proportions and that preparers had to work long hours to prepare notes that users mostly neglected. The representative of the Confederation of Danish Industry suggested proposing that the IASB should eliminate an old disclosure requirement for each new one proposed. The EFRAG Chairman noted that EFRAG wanted to develop principles for disclosures.

One participant noted that it was difficult to strike the right balance. There was consensus that disclosures should be tailored to the activity of an entity and that materiality was a key concept. The representative of the Confederation of Danish Industry noted that, in Denmark, materiality was applied very literally and asked whether it was the same in other countries. The participant that represented the Danish regulator noted that similar feedback was received from other European countries, and that regulators were considering how to apply materiality to disclosures. However, he did not think that regulators may sanction an entity to give too much detail. Another participant noted that the critical issue was to identify the appropriate trigger to require disclosure in each standard.