EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

ANC

PARIS – 24 MAY 2011

PANEL

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- Jérôme Haas – *ANC Chairman*
- Philippe Danjou – *IASB member*
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PROJECTS DISCUSSED

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

Note: the Leases session was conducted first.

DISCLAIMER

Executive summary

Recognising progress made by the IASB in taking into account comments expressed, participants however expressed general discomfort regarding the multiplication of processes and the speed of re-deliberations, noting also that sometimes decisions are reversed. Following the whole process is, with the best will possible, extremely difficult.

Despite some of the decisions being considered as going in the right direction, participants were not convinced that there was a need to overhaul the existing standards, especially if new proposals were to imply changes to the business model of companies. In addition there was a strong call for both projects to be thoroughly tested and re-exposed.

Introduction

During the re-deliberations process, the IASB made notable 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.

ANC Chairman preliminary remarks

The Chairman of the ANC reminded participants that for the ANC a new IFRS standard should:

- Respond to a demonstrated and widely agreed upon need;
- Have concepts that are clear, well understood and applicable;
- Not entail changes to companies business models but rather reflect the way companies operate;
- Be thoroughly tested prior to issuance to ascertain the above.

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.

Participants did not express any views on this issue.

Timing of revenue recognition

Percentage of completion accounting

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.

One participant noted that, based on the preliminary assessment of the new proposals, the French construction industry would be able to continue applying the percentage of completion method to revenue recognition in most cases, in which it was applied at present. The criterion that made this possible was the 'right to payment'. However, the participant noted that it was important that the right to payment could be implicit, for example, due to a national law, and would not necessarily have to be stated in the contract. The IASB member confirmed that it was intended that implicit rights to payment should be considered.

Another participant wondered whether the new requirements would continue allowing categorising contracts, in the way it was done at present, in order to determine whether percentage of completion should apply. The IASB member replied that if the contracts were standardised, the entity would not have to analyse every single contract. However, if every contract was different, the contracts had to be analysed individually.

The EFRAG Chairman noted that during other outreach events, participants from the software industry expressed concerns about the new proposals as they believed that it would not be feasible to apply percentage of completion accounting where it was applied at present. The

IASB member replied that the meetings the IASB had had with the software industry had left the impression that the industry was content with the criteria.

The subject of costs was also discussed with participants regretting that the project would lead to a deletion of the current guidance related to costs to take into account in percentage of completion accounting. Also another participant mentioned the issue of capitalisation of acquisition costs and expressed the concern that the pattern of revenue recognition should not be affected by the distribution channel as that would distort comparability and not reflect a true and fair view of the business. A question was also raised about how the revenue standard proposal should translate in the customers' books. The Chairman of the ANC underlined the cross-cutting aspect of the issue and the importance of the concepts level.

Limitations on uncertain amounts

IASB tentative decision

The IASB had 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).

A participant from the pharmaceutical industry noted that the IASB's tentative decision to introduce the restrictive criterion of the customer's ability to avoid paying addressed the concern that the pharmaceutical industry expressed in relation to royalty-based revenue. The IASB's exposure draft on revenue from contracts with customers would have resulted in revenue from licences being recognised as soon as the customer was able to use the licence. The pharmaceutical industry raised a concern that royalties from a license often were proportional to the sale made by the customer using the licence. Therefore, the pharmaceutical industry believed that revenue should not be recognised prior to the customer making its sale.

The IASB member noted that the IASB might need to re-consider the customer's ability to avoid paying criterion, as it also had implications for other transactions and industries than those originally intended. The participant from the pharmaceutical industry thought that this was unfortunate as the criterion had solved the royalty issue. However, if the IASB were to remove this criterion, the license agreements in the pharmaceutical industry should be analysed as revenue sharing contracts, and the final standard should specify that, revenue should not be recognised prior to the sale to third parties in such circumstances.

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.

One participant noted that accounting for the time value of money would be more complicated than most people expected. The participant also suggested that the time value of money was associated with financial instruments rather than with revenue recognition, as it related to the receivable from the customer and not to the contract to provide goods or services to the customer.

Another participant mentioned that the time value of money is already taken into account when applying the percentage of completion method, at present, and hoped that the final requirements would not modify the conditions, in which it is done. The participant mentioned that, should the financing element be material, it would be appropriate to take it into account, whichever way it occurs, i.e. also in the case of pre-financing / pre-payments.

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).

The discussion focused on whether the new proposal was consistent with the requirements for financial instruments, and if it was then why the impairment of trade debtors was addressed in the revenue recognition standard and not in the standard on financial instruments.

The IASB member noted that the new proposal was consistent with the requirements for accounting for impairment losses on financial instruments. However, he also mentioned that the IASB had not finalised its discussions about impairment losses on trade debtors.

A participant asked whether the impairment losses would be recognised based on the expected or incurred losses. The IASB member replied that it would depend on the entity. If an entity could make predictions about losses, then it would recognise the expected losses. If the entity was not able to make such predictions, it would be incurred losses.

Other issues

A representative of the telecom industry, without re-exposing the details and noting that the industry had had an educational session with the IASB, expressed that the telecom industry still had major concerns about the proposals. The IASB member mentioned that the IASB still had to make a decision on the subject.

The question was also raised about when real tests would be performed on the proposed standard. Participants also expressed the view that the proposals should be re-exposed.

Leases

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

- Scope and definition of a lease;
- Different models for different types of leases;
- Purchase and renewal options;
- Contingent payments;
- Short-term leases;
- The accounting models for lessors.

Scope and definition of a lease

IASB tentative decision

The IASB had tentatively re-affirmed that entities are not 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*.

Also, 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.

Participants discussed the dividing line between leases and services and whether intangible assets should be included in the scope of the standard. The IASB member noted that the IASB had decided that entities should not be required to apply the standard on leases to intangible assets. He also mentioned that the IASB acknowledged that there would be a difference between accounting for services and accounting for lease agreements. The IASB project manager added that, in general, fewer agreements might be in the scope of the new leases standard, than at present under IAS 17, as not only some intangible assets had been scoped out. For example, capacity contracts had been scoped out as well. In addition, the proposed requirement to account for an entire contract as a service, if the asset within the contract could not be separated, might also reduce the number of contracts in the scope of the standard.

One participant noted that on this issue the project was moving in the right direction. However, he was concerned that the accounting requirements for leases were so different from the accounting requirements for services. He also noted that it was unfortunate that the standard did not address accounting for leases of intangible assets, because the economy was more and more based on services and intangible assets. Also, the participant, although agreeing that, prior to the previous week's Board decisions, the IASB was heading in the right direction, still questioned the overall objective of the standard.

Participants discussed whether cars, which an employer rents for the employees, were included in the scope of the standard. They argued that it was not the entity, but the employees who received the benefits from the cars. Therefore, participants believed that the rented cars would not qualify as lease arrangements under the new proposals. The IASB project manager noted that deciding on whether it was a lease agreement or not would depend on the actual facts and circumstances. The IASB member added that one should consider whether the entity could operate without the cars in determining whether the contract was a lease. If not, the entity seemed to benefit from the cars. However, before concluding that the contract was a lease agreement, one should also consider if the cars could be separated from related service and maintenance agreements included in the contracts.

The Chairman of the ANC noted that the difficulties encountered with the topic derive from the approach taken and that if there wasn't an asset to be recognised as per the approach, there wouldn't be an issue. He further expressed the fact that there should have been a discussion on the quality and best placement of the information relating to operating leases (balance sheet or notes to the financial statements). At any rate, the rationale for taking the approach should be very explicitly explained.

One participant noted that sometimes service contracts were very similar to contracts that would fall in the scope of the new standard and would be accounted for as leases. Therefore, he inquired about the rationale for requiring recognition of assets included in a lease contract, whilst nothing had to be recognised if it was a service contract. The IASB member replied that although some lease agreements were very similar to service contracts, other lease agreements were very different. That was the result of having to make a borderline between a service and a lease. The users of financial statement had told the IASB that leases should be recognised on the balance sheet, and therefore, the IASB had to determine what a lease was, and some borders had to be drawn. The IASB project manager explained that users were not very specific about what they considered to be a lease. However, it was about risk and rewards related to having an asset. She thought that leased assets on the balance sheet could provide important information to the users, because of the different risk patterns between services and leases. The Chairman of the ANC did not think it was true that users wanted leased assets to be recognised on the balance sheet. The IASB member explained that the conclusion came from the comment letters, which the IASB had received from the users on this issue.

Another participant noted that it was necessary to clarify the notion of the “specified asset”. For example, if a contract specified a photocopier with a particular number, but the customer did not object to another photocopier, was that photocopier a specified asset? Additionally, what would happen if the customer had the right to have something replaced? The IASB project manager explained that it was important not to confuse the requirement with warranty provisions. In other words, one should not consider what would happen if the photocopier would break down. The ANC Chairman noted that the issue related to whether something was a specified asset or not did not exist under the present practice.

Participants also discussed whether intangible assets should be included in the scope of the leases standard. The IASB member explained that the IASB could either:

(a) allow application of the standard to leases of intangible assets as an option (that was currently suggested); or

(b) include in the scope of the new standard only those intangible assets, which were currently in the scope of IAS 17, or all intangibles. In this case, the IASB would have to consider the effects, and it could result in having to start all over again.

Participants noted that the IASB should at least examine the effects of including intangible assets in the standard.

Different models for different 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 asked participants about their preferred accounting for leases if all leased assets had to be recognised on the balance sheet, which was not the participant's preferred model.

Some participants suggested a linked model, under which the liability would be measured at the undiscounted amount of future lease payments and the asset would be measured at the same amount. As the lease liability was not a financial item, it was considered appropriate to leave the amount undiscounted. The IASB project manager noted that the solution would work when the lease payments were equal amounts. However, if the payments were of different amounts, the model would result in a wrong measurement of the leased asset. One participant noted that the value of the leased asset at any point in time was equal to the amount of the remaining lease payments, as it was the value considered by the lessee in deciding whether to continue leasing the asset or not.

Participants discussed whether the sum of future lease payments would represent the value of a leased asset. The IASB project manager noted that although lease payments for a car could be of the same amount over three years, a customer would not pay the same amount for a new car and for a car that had been used for two years. A participant noted that for a building, the amount paid would probably not depend on the age of the building. He thought that in the car lease example, the key factor for determining the price of the rent was not the age of the car, but the number of kilometres that the car should run per year. He therefore, thought that the difference between the price of renting a new car every year (for three years) and renting the same car for three years was due to a rebate offered to the customer in exchange for the customer's commitment to rent a car for three years, instead of only one year at a time.

The IASB project manager noted that the IASB believed that all lease agreements included a financing element. Participants in the meeting affirmed that not all leases were the same, and that it was necessary to distinguish between "finance" and "other-than-finance" leases.

The ANC Chairman asked participants whether all leases should be capitalised. They did not believe so. Participants wondered why it was not possible to simply improve the current IAS 17.

One participant thought that if the IASB wanted to replace IAS 17, the new proposal had to be less costly to apply than IAS 17. However, this did not seem to be the case.

Another participant noted that it was complicated to calculate the lease liability under the new proposals, where it should be calculated for all leases. She feared that including operating leases on the balance sheet would entail a business change for the lessors as their customers may no longer conclude lease contracts.

The IASB project manager noted that if some leases were not included on the balance sheet, then users would try to include them themselves. Therefore, some preparers wanted to include all leases on the balance sheet in order for the figures to be as useful as possible. The ANC Chairman replied that preparers did not want to recognise all leased assets on the balance sheet.

The IASB member explained that the cost/benefit issues were still subject to consideration by the IASB.

The EFRAG Chairman concluded that participants generally believed that other-than-finance leases should not be capitalised, but if they should, the linked model should apply.

Purchase and renewal options

IASB tentative decision

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

- the rentals in the optional period are at favourable terms;
- the lessors 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 should be treated in the same way.

Some participants found it difficult to understand the basis for the IASB's decision regarding options. It was noted that, as per the proposals, economic incentives should be considered.

However, in relation to liabilities, the IASB had decided that economic compulsion should not be considered. Participants found this inconsistent and questioned whether the requirement was simply an anti-abuse measure.

The IASB member agreed that there was a cross-cutting issue with liabilities, and that the IASB was aware of it.

The IASB project manager explained that if a lease was priced on the assumption that the option would be exercised, and that option was not considered, there could be some unintended accounting consequences. Therefore, it was necessary to take certain options into account.

One participant argued that options should not be taken into consideration, noting that options were included in contracts because often lessees were not certain about what they would do. The participant was representing a lessor. They had tried to predict what lessees would do, however, the results were not successful.

The IASB member thought that it was possible to make some expectations. For example, if a lessee was offered an option to lease a car for one euro for two years after it was leased for three years for a much higher amount. A participant argued that such options were not genuine.

Participants suggested that options should not be considered unless the options were "not genuine" (that is when the lessee, from an economic point of view, did not really have a choice).

Contingent payments

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.

Rentals that are contingent on an index or rate should be initially measured based on the spot rate.

Participants were generally content with the IASB's tentative decisions.

One participant noted the fact that contracts with variable payments were in effect a different business model where the objective was of profit sharing and agreed that those should not be captured by the standard.

Short-term leases

IASB tentative decision

The IASB had 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 would 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 noted that the 12-months requirement did not work well. The IASB member explained that the IASB could either use a materiality threshold, which could be costly to apply, or a practical expedient, as in this case. The participant thought the issue related to the definition of a lease. If an agreement was for a period less than 12 months, a right of use might not exist.

However, no participant wished to remove the exception.

Lessor accounting

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

The IASB member noted that there was currently no consensus amongst the IASB members on whether there were one or more types of leases for lessors.

Other issues

The IASB member noted that the IASB hoped to be able to issue something on leases in June or July 2011. Participants thought that the IASB had to issue a new exposure draft on leases. There was doubt as to whether the IASB could finalise their re-deliberations that quickly, based on the list of the outstanding issues. The issue of actually testing was also brought up.

Comment made aside from Leases and Revenue Recognition

Participants expressed frustration about the package of consolidation standards (IFRS 10 – 12) being finalised without any form of re-exposure, as the drafting of the standard was substantially modified after the exposure draft. Participants noted that it would take time to understand the requirements and that assessing their application would be a very time consuming process not fitting with the effective date of 2013.