EFRAG

European Financial Reporting Advisory Group

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

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OIC

ROME - 5 MAY 2011

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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 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. EFRAG will consider issuing a comment letter on those documents.

Revenue Recognition

The discussion focused on developments relating to:

- Disaggregation of contracts;
- Timing of revenue recognition; and
- Cost 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.

Representatives for both the construction and software developing industries that participated in the event, expressed a view that the IASB was moving in the right direction by having tentatively decided to require 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. However, some participants noted that the IASB should be very precise in describing what an integration service was. Otherwise the term would be interpreted differently by different companies and auditors. This view was shared by auditors who participated in the event.

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 for convenience.

Representatives of the construction industry that participated in the event, raised a concern that it was not clear when a customer controlled the asset being created or enhanced, and suggested the IASB to clarify this. A representative of software developers raised concerns about the requirement of 'not creating an asset with an alternative use'. The percentage of completion accounting was currently applied for development of software specified by customers. However, it was clear that the software, which was developed specifically for a particular customer, in many cases could be sold to a third party as well. It was considered that under the new proposals, the percentage of completion accounting could no longer be applied in such circumstances. In addition, a representative of an aircraft manufacturer noted that a plane ordered by, and being constructed for, one customer could be sold relatively easily to another customer.

In general, participants suggested that the requirement of 'not creating an asset with an alternative use' should be removed. They also suggested that the percentage of completion accounting should only be applied when an entity had a right to payment for performance to date, even if the customer could cancel the contract.

Cost and benefits

At the event, comments in relation to cost and benefits considerations were expressed in relation to:

- accounting for the time value of money; and
- accounting for the credit risk.

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.

Representatives of the construction industry that participated in the event noted that despite the tentative decisions in relation to time value of money, which were made by the IASB during the re-deliberations, the proposals would be very costly to apply to advances received under the percentage of completion accounting. They considered it unnecessary to account for the time value of money, as it appeared clearly from the balance sheet how the entity financed its construction work. Also, it was considered to be impossible for many contracts to demonstrate that the amount of customer consideration would not be substantially different if the customer paid in cash at the time of transfer of goods or services.

One preparer noted that it was difficult to distinguish between credit risk and interest when considering time value of money.

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 recognise an allowance for any expected impairment loss from contracts with customers. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item (as contra revenue).

An auditor who participated in the event suggested that subsequent impairment losses should be presented in a line below the gross margin named “unusual items”. It was argued that most often initial impairment losses would be zero, as an entity would not sell goods or services to a customer from whom it did not expect to receive any payments.

One preparer asked about the presentation of costs of selling trade receivables in the income statement. It was noted that the issue would be brought to the attention of the IASB.

Other issues

A representative of the telecommunications industry disagreed with revenue being allocated to a handset provided to the customer upon signing a contract. In addition, allocation of the total transaction price to all performance obligations on a contract-by-contract basis caused significant concerns. It was noted that it could only be done on a portfolio level.

On the allocation of the transaction price to different performance obligations, a representative of the energy sector suggested that the amount allocated to a particular performance obligation should only be the amount that was expected to be received for that service. In some cases (for example, when services were provided to the Italian government) the amount of consideration the government was willing to pay was uncertain. In addition, often right to consideration was dependent on the savings reached by the customer.

Leases

Definition of a lease

IASB tentative decision

During the re-deliberations, the IASB had 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 long-term lease of cars met the definition of a lease. The IASB project manager that participated in the event noted that one would need to assess whether the customer had the ability to direct the use of the cars, i.e. decide to what purpose and how it would be used, who would drive it, etc.

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. It also had 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 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.

Only a few participants expressed a view.

Some participants believed that not all leases were the same, hence broadly supporting the direction of the IASB's re-deliberations.

One participant believed that all leases contained a finance element. In addition, the participant considered the requirement to apply the annuity depreciation method to other-than-finance leases contradictory, as it implied the use of a financial depreciation method to leases that were deemed other-than-finance. Therefore, the participant was supportive of a single type of lease with a constant depreciation charge.

One participant asked where amortisation and interest costs would be presented in profit or loss. The IASB project manager that participated in the meeting clarified that presentation issues had not been re-deliberated yet.

Options

IASB tentative decision

The IASB had 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.

Overall, the direction of the IASB's re-deliberations on this issue was supported as an improvement compared to the exposure draft, however some concerns remained.

Contingent rent

IASB tentative decision

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

Participants did not express significant concerns on this issue.

A representative of OIC questioned whether the guidance on contingent rent was consistent with other standards dealing with contingent consideration. The IASB project manager that participated in the meeting noted that the current definition of a liability in the Framework can be interpreted differently. That is why there is no unanimous view by the boards on this issue.

Scope of the Standard

IASB tentative decision

The Board had tentatively re-affirmed that entities are not required to apply the standard to leases of intangible assets. The Board had added a scope exemption for the arrangement in the scope of IFRIC 12 *Service Concession Arrangements.*

Participants did not express significant concerns on this issue.

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

Participants did not express significant concerns on this issue. One participant argued that non-core assets should not be recognised in the statement of financial position. The IASB project manager that participated in the meeting noted that determining the criteria for distinguishing between core and non-core assets was complex, and therefore those assets are required to be included. However, one should take materiality into account.

Sale and leaseback

IASB tentative decision

The IASB now proposes that an entity should apply the control criteria described in the revenue recognition project to determine whether a sale has occurred. The IASB had decided that the leases guidance would not prescribe a particular type of lessee accounting model for entities that are accounting for the leaseback part of a sale and leaseback transaction.

Participants did not raise comments on this specific issue.