European Financial Reporting Advisory Group

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

EFRAG

GASB

FRANKFURT – 9 MAY 2011

PANEL

- Carsten Zielke – *EFRAG TEG member*
- Liesel Knorr – *GASB President*
- Elke König – *IASB member*
- Gabi Ebbers – *EFRAG TEG member*
- Friederich Siener – *EFRAG TEG member*
- Rasmus Sommer – *EFRAG project manager*

PROJECTS DISCUSSED[1]

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

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.

[1] It is noted that in addition to the IASB's projects on revenue recognition and leases, the projects on financial instruments and insurance contracts also were discussed at this meeting. However, the latter two are covered in a separate note.

EFRAG
European Financial Reporting Advisory Group

Introduction

During the re-deliberations process, the IASB has 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.

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.

The views of participants on this issue varied.

One participant broadly supported the direction of the IASB's tentative decisions in relation to unbundling requirements. However, noted that additional guidance was required to determine whether the resulting bundle should be accounted for as a good or a service when an integration service was provided.

Conversely, another participant suggested that it would be costly and time consuming to identify separate performance obligations based on the tentatively agreed criteria.

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

- o the entity has a right to payment for performance to date.

A representative of the German Accounting Standards Board noted that the new proposals would result in the percentage of completion method being applied in similar circumstances to those, in which it is applied today under the current standards on revenue recognition. He also believed that “contracts for work and services” (“Werkvertrag”) in accordance with the German commercial code would not meet the criteria for the “continuous transfer”, and therefore would not qualify for accounting using the percentage of completion method.

A participant from the construction industry supported the direction of the IASB’s re-deliberations on this issue. However, he was concerned that the requirements regarding customer acceptance clauses, which were included in the exposure draft and had not been re-deliberated yet, represented a significant obstacle for application of the percentage of completion accounting.

A participant from the software industry raised a concern that development of software is also unlikely to satisfy the criteria for the “continuous transfer”, and therefore would not qualify for accounting using the percentage of completion method. This was perceived as an unwelcomed change from the current practice. It was also perceived that business of entities that sold intellectual services had not been considered properly in developing the tentative decisions on the application of the percentage of completion accounting.

Some participants questioned whether the “alternative use of an asset” was a necessary criterion for determining whether the percentage of completion accounting could be applied. The GASB president noted that the IASB’s argument, that this criterion was intended to prevent from revenue being recognised on inventory, was not convincing. The standard addressed revenue from contracts with customers, whilst for inventory there was no contract with a customer.

One participant suggested that further guidance should be provided to clarify when a customer controlled the work-in-progress. The IASB member that participated in the meeting agreed with the comment and assured that the IASB staff was working on the issue.

Limitation for 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).

The new proposals were generally welcomed. Several participants noted that they supported the limitation for uncertain amounts, which was within the control of the customer. This proposal was considered to be consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and to reflect internal reporting. It was also suggested that this requirement should apply to leases.

A participant from the software industry expressed a concern that under the new proposals one would be recognising revenue at the lowest possible price. For example, if a customer was entitled to a quantity discount, then under the new proposals the revenue would reflect the lowest possible price per unit that the customer could be paying until it was certain that the customer would not qualify for the discount. The IASB member that participated in the meeting noted that this was not the IASB’s intention, but the issue would need to be considered further.

One participant raised a concern that the new proposals could be difficult to apply to contracts, which included a clause of “best efforts” to sell a particular product using a certain licence. Generally, under such contracts it would be difficult to determine the amount that the customer could avoid paying without breaching the contract.

Some participants asked what would happen to long-term supply arrangement containing a minimum sales amount. The IASB member that participated in the meeting noted that the accounting outcome would depend on the facts and circumstances.

Costs and benefits

A participant from the construction industry noted that the new proposals, in general, would require a lot of judgement to be applied. This would involve more time and higher costs for preparing financial statements. In addition, this also could result in delaying the publication of financial statements.

Time value of money

IASB tentative decision

At its March 2011 meeting, 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 when the entity transfers the promised goods or services to the customer and 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 the requirement to adjust revenue for the time value of money could be very difficult to apply under the percentage of completion method.

Another participant suggested that these requirements should be aligned with the requirements in relation to financial instruments in order to ensure that if a contract included a significant financing component and revenue was adjusted for the time value of money, the corresponding receivable was discounted as well.

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).

The direction of the IASB re-deliberations was generally supported and the tentative decisions were perceived as an improvement to the original proposals in the exposure draft. However, one participant suggested to include a rebuttable presumption in the standard that the credit risk would not be material (i.e., similar to the decisions on the time value of money).

One EFRAG member that participated in the meeting expressed support for the IASB's tentative decision to show the credit risk in a separate line.

One participant raised a concern that the net revenue figure could be negative. However, if the focus was on the gross revenue, the IASB's tentative decision provided a good solution.

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.

A participant from the software industry expressed support for the IASB's tentative decision to allow the residual method for estimating a standalone selling price. However, further guidance was required for cases, in which the price of two or more performance obligations within a contract was uncertain.

Use of weighted-average amounts

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 participants overall supported the IASB's tentative decision on this issue.

Other comments

One participant did not believe that the proposals overall resulted in an improvement compared to the existing standards on revenue recognition, and therefore, did not think that a new standard should be issued.

The GASB President noted that the new standard would not result in changes for most entities, and that the proposed changes were an improvement. This was a shared view, especially in relation to multiple-elements contracts.

The IASB member that participated in the meeting reminded participants that this was a convergence project and probably, the final standard was much closer to the current European than the current U.S. practice.

Other remarks

The GASB President noted that it seemed as if the project was moving in the right direction. However, it would not be possible to make a final judgement until the wording of something close to a final standard was ready.

Leases

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

- The accounting models for lessees,
- Purchase and renewal options,
- Contingent payments,
- Scope,
- Short-term leases,
- Sale and leaseback transactions,
- The accounting models for lessors.

The accounting model – lessees

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.

It is worth noting that subsequent to the outreach meeting, in May 2011 the IASB decided to revert to a single model because of conceptual and application concerns.

A participant from the leasing industry supported the IASB's tentative decision to distinguish between the two types of leases, as he believed that the users of financial statement were not supportive of the right-of-use approach proposed in the exposure draft. That participant believed that it was useful to distinguish between finance and other-than-finance leases. However, it was noted that IAS 17 already included such a distinction; therefore it was difficult to see the benefits of introducing a new lease model.

An EFRAG member that participated in the meeting noted that the new proposals differed from the current IAS 17, as all leases would be recognised on the balance sheet. He also noted that the users, for example, credit agencies, argued for all leases to be included in the balance sheet, as currently they need to adjust the amounts presented in the financial statements to reflect the assets and liabilities arising from operating leases. That would be unnecessary under the new proposals. However, he also acknowledged that it could be costly for the preparers to recognise all leases, including many small amounts, on the balance sheet. The IASB member that participated in the meeting also disagreed with the conclusion that the tentative decisions lead to a model similar to one in IAS 17. Under the new proposals all leases would be recognised in the balance sheet, except for short-term leases. However, not all leases were finance leases.

Some participants were critical about the new proposals to depreciate other-than-finance lease assets differently from other assets. He believed that information produced under the current IAS 17 model was easier to understand for the users of financial statements. This view was shared by other participants

The GASB President noted that the proposed amortisation pattern for other-than-finance leases could lead to more impairment losses.

A GASB member that participated in the meeting suggested that all leases should be accounted for in a similar manner and that short-term leases should be scoped out from the standard.

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 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 should be treated in the same way.

Some participants raised questions and concerns about the "significant economic incentive". First of all, it was unclear from whose perspective the significant economic incentive had be considered. In addition, it was also unclear how often an entity would be required to assess whether a significant economic incentive existed. Some were concerned that whether or not such an incentive existed could vary from one accounting period to another, and it could be time consuming to account for the changed circumstances.

An EFRAG member that participated in the event noted that information following from the reassessments could, in some cases, be valuable.

One participant inquired about the accounting treatment for agreed leases without an expiration date for the contract, with a required termination notice of less than a year, for example, 3 months. Such type of rent agreements is common in Germany. The IASB member that participated in the meeting noted that the issue will be brought to the IASB's attention.

Contingent payments

IASB tentative decision

The IASB had proposed that parties include 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.

One participant raised a question about accounting for a change in an index subsequent to the initial measurement (e.g., change in the inflation rate). That participant suggested that it could be easier to recognise such changes in the income statement when the changes occurred. Another participant raised a concern that the new proposals were inconsistent with the proposed requirements for contingent payments in the revenue recognition standard.

The IASB member that participated in the meeting replied that the IASB had to consider cross-cutting issues and there should be a good reason for having different requirements in the different standards. If good reasons existed, different requirements were justified.

One participant suggested that a cap on revenue recognition introduced in the revenue recognition standard (revenue could not be recognised if the customer could avoid paying an additional amount of consideration without breaching the contract) should also be applied to leases.

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*.

The views of participants on this issue were split.

A participant from the audit profession raised concerns about scoping the intangible assets out of the leases standard. He found it contradicting with the proposal to recognise right-of-use assets, which themselves were intangible assets. He also pointed out that the IFRS Interpretation Committee was considering some issues related to intangible assets, which seemed like lease agreements, and was awaiting the outcome of the lease project.

The GASB President noted the decision to exclude intangibles from the scope of the project reflected the fact that the IASB could not do everything at the same time.

A participant from the software industry noted that including intangible assets in the scope of the standard could lead to a number of issues. One issue was that a lessor could grant a right to use an intangible asset to many lessees at the same time. Therefore, he supported the exclusion of intangible assets from the scope of the leases 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 assets not to recognise assets and liabilities arising out of lease arrangements.

It was tentatively decided that in that case lessors and lessees 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.

In addition it was tentatively decided to define a short-term lease, 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.

In general, the participants supported the direction taken by the IASB in its re-deliberations of the proposals in relation to short-term leases. No specific concerns were expressed on this issue.

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.

No comments were made on this issue.

The accounting model - lessors

IASB tentative decision

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

A number of participants noted that it was important to address accounting for lessors and that the requirements for lessors should be consistent with those for lessees. The IASB member that participated in the meeting noted that the IASB intended to address accounting for lessors.

One participant noted that the performance obligation model would not work for lessors. That participant also did not support the proposal to “freeze” the residual value. In addition, he raised significant concerns about the IASB’s tentative decision in respect of separating lease and non-lease components of a contract. According to that decision, if there were no observable purchase prices, the lessee would have to account for all payments required under the contract as a lease. That proposal was considered to be a “punishment” for lessees.

Other issues

The IASB member that participated in the meeting noted that the IASB would consider the need for re-exposure when something that could be a final standard had been developed.