

EUROPEAN OUTREACH ON THE IASB'S MAIN PROJECTS

**EFRAG
UK ASB
ICAEW**

LONDON - 10 MAY 2011

PANEL

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PROJECTS DISCUSSED

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

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Introduction

During the re-deliberations process, the IASB has made some significant changes to its original proposals, in order to respond to comments received in public consultation, in relation to projects leading to the new IFRSs on revenue recognition and leases. 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.

Executive summary

Overall, participants supported the direction taken by the IASB in the re-deliberation of the proposals in relation to revenue recognition. However, some concerns were raised, in particular, in relation to guidance on “continuous transfer” and proposals on time value of money and presentation of the credit risk.

The new proposals on leases did not receive much support, and a large number of participants believed that it would be preferable to keep IAS 17 *Leases* rather than to proceed with the new model.

Revenue Recognition

Overall, there was support for the project and for development of a single model for revenue recognition. Only a few participants believed that IAS 18 *Revenue* was not broken.

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.

There was not much debate in relation to disaggregation of contracts, as it seemed that this particular issue did not cause much concern in the UK at the exposure draft stage. However, some participants noted that the new proposals represent an improvement compared to the proposals in the exposure draft.

One participant from an audit profession commented that the notion of integration service could be used to avoid separation of performance obligations, and raised the question of how to draw appropriate boundaries and avoid abuse. It was understood that changes to the proposals on separation of performance obligations were made in order to address concerns of the construction industry. However, the new proposal might cause issues for the software developers as it was not clear what could be considered as an integration service in that industry, and therefore which performance obligations under a contract could be bundled. There was a concern that some companies could start bundling performance obligations, which should not be bundled.

In addition, this participant also raised a concern about tailoring proposals in response to concerns of particular industries, as the objective of the project was to develop a *single* principle-based model for revenue recognition.

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.

It is worth noting that under the UK GAAP, revenue is recognised as the seller obtains a right to consideration in exchange for its performance. In addition, there is a specific guidance in the UK GAAP (UITF Abstract 40) that addresses accounting for revenue from services rendered by professional service firms.

Overall, participants believed that the new proposals represented an improvement compared to the proposals in the exposure draft.

One participant from the professional services industry noted that it was not appropriate to “divorce” the criteria for revenue recognition, and that the performance and the right to consideration should be considered together. Another participant from an audit profession noted that the concept of “continuous transfer” should be developed further and more guidance should be provided, as it proved to cause problems in practice, for example, in relation to IFRIC 15 *Agreements for the Construction of Real Estate*. These issues are under consideration of the IFRS Interpretation Committee at present.

One participant raised a question as to whether the transfer of goods or services would be assessed from the customer's or the supplier's point of view. The IASB staff that participated in the meeting clarified that it would be the supplier's perspective.

The participants were asked whether the new IFRS on revenue should be based on the "right of consideration" model (similar to the UK GAAP). No views were expressed.

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. 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).

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 and also provide that customer with a handset. At present, in such situations revenue could be 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, since 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.

There were no major comments on the subjects of non-contingent revenue and limitations on uncertain amounts from participants, except that the proposals would be difficult to apply for the bio-tech companies in a start-up phase, as they would not have sufficient data. An IASB Board member that participated in the event noted that, in relation to uncertain consideration, the objective was to ensure consistency with the respective proposals on leases, and that uncertainty was considered in measurement rather than as a recognition threshold.

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;
- accounting for the credit risk;
- allocation of transaction price to separate performance obligations; and
- use of probability weighted amounts.

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.

Overall, participants supported the direction taken by the IASB in relation to the accounting for the time value of money. However, significant reservations were expressed in relation to the proposed presumption that contracts with the timing difference between the payment by the customer, and the transfer of the promised goods or services of twelve months or less, do not have a significant financing component. This could be true in a stable economic environment, but would not work otherwise, for example, in a hyperinflationary economy. It was suggested that the “bright line” of twelve months should be removed and that the criteria should be refined.

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), but not as an operating expense.

Overall, participants supported the direction taken by the IASB in relation to the accounting for the credit risk. However, significant concerns were raised about the proposed presentation of the credit losses right under the revenue line in the income statement. Some participants noted that IAS 1 *Presentation of Financial Statements* is rather flexible; therefore, the final standard on revenue should not mandate where to present certain items.

One participant raised a concern that under the percentage of completion accounting, an expected impairment loss would be recognised for the entire amount of consideration upfront, whilst revenue would be recognised over time, as goods or services are transferred continuously.

Allocation of transaction price to separate performance obligations

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 few participants supported the new proposals. There were no specific views expressed on this issue.

Use of probability weighted 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.

Some participants believed that the new proposals represented an improvement compared to the proposals in the exposure draft, but a few participants had reservations, especially in relation to the most likely amount.

One participant from an audit profession suggested that the standard should outline a principle for measuring revenue, and that fair value of consideration received or receivable would be the right principle to apply.

Other issues

One participant suggested that the new revenue standard should provide guidance on fees paid by suppliers to retailers for displaying their goods in a particular way (“slotting fees”). The issue is whether, in supplier’s accounts, this fee should reduce revenue or be presented as a cost item. The IASB staff that participated in the meeting referred to the relevant guidance in the proposals, which suggested that to decide on the presentation one would need to determine whether a fee was paid for a separate service provided by the customer, or represented a rebate.

Another participant raised concerns that guidance on incremental costs incurred in securing an investment management contract, which is currently included in IAS 18 (Illustrative Examples, paragraph 14(b)(iii)), was not carried forward to the new standard.

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 noted that the original objective of the project was to bring liabilities on the lessee's balance sheet, and further asked whether the IASB was still pursuing this objective. The EFRAG member that participated in the event noted that the objective was to bring on liabilities that an entity incurred in acquiring an asset, but not to recognise commitments. One IASB member that participated in the event noted that the IASB was not trying to change significantly the definition of the lease, nor put executory contracts on a balance sheet. The objective was to refine the definition to capture the appropriate items in the financial statements.

Some participants asked for more detailed guidance on how to assess the existence of a right to control the use of the underlying asset. One participant challenged the tentative decision that the

lessor's ability to replace the underlying asset was a sufficient criterion to conclude that the transaction did not include a lease.

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.

The view of participants on this issue varied. The majority of participants were in favour of retaining the current requirements in IAS 17. Some participants noted that they were confused by the new proposals, because they drifted away from the original principle and the objective introduced in the exposure draft (i.e., a single right-of-use model). It was also noted that one bright line was removed (i.e., currently IAS 17) and another was introduced. Conversely, some other participants supported the new proposals as a practical solution, which would help to understand the results in profit or loss.

One participant from the audit profession expressed support for the effort to find the right solution, but was not sure whether the new proposals were better than current IAS 17. That participant also suggested that the IASB should address the fundamental issue of executory contracts.

A number of participants noted that, in the UK, a decision to enter into a lease of premises, in a large number of cases, was not a finance decision, but an operating one, because it would often be impossible to buy them. Taking this into consideration, one participant suggested that the re-deliberations were inconsistent with the right of use model, and that he could see arguments for having annuity depreciation only in the case of real estate.

An IASB member that participated in the meeting noted that a number of constituents agreed that the expense should not be frontloaded, but disagreed with the results of the re-deliberations, and asked whether participants had alternative suggestions. He also noted that the underlying

basis for the tentative decisions reached in the re-deliberations was that the unit of account was the lease contract rather than the right of use asset.

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.

Participants agreed with the direction taken by the IASB on these topics, but some suggested that more explicit guidance was required in relation to the application of “significant economic incentive”.

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.

Participants overall expressed support for the direction taken by the IASB on this issue.

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.

In general, participants supported the new proposals; however some noted that the exemption should be based on some sort of materiality notion instead of a bright line of 12 months.

Other comments

There was a discussion about the use of the incremental borrowing rate. One participant argued that credit risk should not be taken into account, especially in real estate. Market rates for a lease did not take into account the credit standing of a potential lease; a rental for the similar premises in the same shopping mall would be the same for a well-known brand and for a local shop.

One participant asked about the re-exposure. An IASB member that participated in the meeting noted that the IASB would consider the need for re-exposure upon completion of the re-deliberation process. However, there was a shared view that the new proposals should be re-exposed.