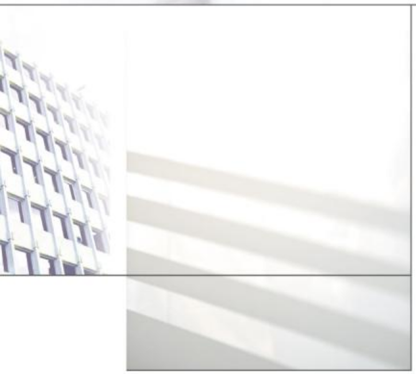

EFRAG

European Financial Reporting Advisory Group

Revenue recogntion and Leases

European outreach - Helsinki

9 May 2011

Agenda

- Welcome and introduction
- IASB tentative decisions and discussion on *Revenue from Contracts with Customers*
- IASB tentative decisions on *Leases* followed by discussion
- Closing

Objectives of the outreach event

- European input to the IASB
  - Assist with finalisation of standards
  - Ensure that final standards are suitable for use in Europe
- Main questions
  - Major concerns about EDs solved?
  - Any new major concerns?

Revenue from Contracts with Customers

Main concerns to ED

- Inappropriate disaggregation of a contract in some cases
- Revenue not always recognised at the right time
- Costly (without additional benefits)

Inappropriate disaggregation

Numerous separate performance obligations

Arbitrary revenue figures

Internal reporting

External reporting

Inappropriate disaggregation

What did the ED say on separate performance obligations?

Does the entity, or another entity, sell an identical or similar good or service separately?

YES → **Separate**

NO ↓

Does the good or service have a distinct function?

NO → **Not separate**

YES ↓

Does the good or service have a distinct profit margin?

YES → **Separate**

NO ↓

Not separate

No need to account separately for goods or services transferred at the same time

Inappropriate disaggregation

What has been done on separate performance obligations?

Is an integration service included for a bundle of goods or services?
- **YES** → **Not separate**
- **NO** ↓

Different pattern of transfer?
- **NO** → **Not separate**
- **YES** ↓

Regularly sold separately by the entity?
- **YES** → **Separate**
- **NO** ↓

Can be used on its own or with resources readily available?
- **YES** → **Separate**
- **NO** ↓

Not separate

EFRAG
European Financial Reporting Advisory Group

Revenue not recognised at the right time: What did the ED say?

- Principle: Recognise revenue when goods or services are transferred to a customer
- Recognise revenue when the customer obtains control of the promised good or service
- Ability to direct the use of, and receive the benefit from, the good or service
- Indicators:
  - Unconditional obligation to pay
  - Customer has legal title
  - Customer has physical possession
  - Customer-specific design or function

Revenue not recognised at the right time

Concerns

1. Less percentage-of-completion (PoC) accounting (construction industry)
2. Does not work for services (transportation sector and other service providers)
3. Will result in revenue being recognised that is contingent on future performance (telecommunications industry)
4. Will result in early recognition of royalties (pharmaceutical industry)

'Less PoC accounting' and 'services': What has been done?

Apply percentage-of-completion (PoC) accounting

WIP is controlled by the customer — YES → **PoC**

NO

Asset with alternative use is created — YES → **No PoC**

NO

Customer receives benefit as tasks are performed — YES → **PoC**

NO

No re-performance needed — YES → **PoC**

NO

Right to payment even if the customer cancels for convenience — YES → **PoC**

NO

No PoC

Transportation services

New York

Copenhagen

“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”

Paris

EFRAG
European Financial Reporting Advisory Group

'Less PoC accounting' and 'services': Concerns resolved?

IAS 11 / IAS 18 / IFRIC 15

- Transfer control and significant risks and rewards or ownership as construction progresses
- Specify major structural elements
- Rendering of services

?

Tentative decisions:

- work on asset controlled by the customer; or
- no alternative use and:
  - benefits as tasks are performed;
  - the obligation changes; or
  - right to payment even if the customer cancels.

’Less PoC’ accounting and ’services’: Concerns solved / new major concerns?

Do the tentative decisions work for service providers?

Do the tentative decisions result in PoC accounting being applied in the right cases?

Non-contingent revenue

Monthly payment

Telecommunications company

Customer

2 years subscription

Status: nothing has been done (yet) – the IASB has identified the issues and will consider them later.

Royalties

Righ to use patent for 10 years

Entity

Customer

Uses patent to produce his/her goods

Sales to third parties

Payment = *factor* * sales to third parties

Only recognise allocated revenue that is reasonably assured.

Not reasonably assured if the customer could avoid paying an additional amount of consideration without breaching the contract (e.g. a sales-based royalty).

Revenue not recognised at the right time

Other main concerns related to the ED's requirement on when to recognise revenue and the re-deliberations?

Costly/complex

Concerns

1. Two-step approach (and considering what other entities do) when identifying separate performance obligations
2. Accounting for numerous performance obligations (construction industry) and modifications of these (telecommunications industry)
3. Accounting for time value of money
4. Credit risk as part of revenue
5. Allocating transaction price (software developers)
6. Use of weighted-average amounts
7. Disclosure requirements

Two-step approach: what did the ED say?

Segmenting of contracts

Step 1	Consider price interdependence

Identifying separate performance obligations

Step 2	Consider what other entities sell and whether distinct function and profit margins

Two-step approach: what has been done?

+	-
Only one step (segmentiation step has been incorporated into the allocation step)	Consider what the customer can do
”Integration service shortcut”	
Other entities not considered	
Distinct profit margin not considered	

Time value of money

- Proposal in the ED
  - The amount of promised consideration reflects the time value of money, if it is material
- Re-deliberations
  - Financing component only if the effects of the time value of money (not the differences in timing) are significant:
    - significant timing difference;
    - significant explicit or implict interest rate; or
    - substantially different price if the customer paid at the time of the transfer.
  - Not required to assess if credit $\leq$ one year

Credit risk

- Proposal in the ED
  - Revenue measured at probability-weighted consideration expected to be received
  - Once a receivable, changes in credit risk do not affect revenue (income or expense)
- Re-deliberations
  - Credit risk does not affect measurement of the transaction price
  - No collectability threshold for revenue recognition
  - Separate line item adjacent to the revenue line for expected impairment losses

Allocation of transaction price

- Proposal in the ED
  - Allocation in proportion to the stand-alone selling price
- Re-deliberations
  - Residual techniques could be applied in estimating stand-alone selling prices for goods or services where the price is highly variable

Weighted-average amount

- Proposal in the ED
  - The transaction price should be the probability-weighted amount of consideration that an entity expects to receive from the customer
- Re-deliberations
  - If the probability-weighted amount will not reflect the amount of consideration an entity expects to receive, most likely amount should be used

Disclosures

Status: nothing has been done yet – the IASB will consider disclosures later.

Other major costs or complexities?

Are there other major costs or complexities to consider?

Other major concerns?

Are there other major concerns to consider?

Leases

Main concerns

- What is a lease?
- Should all leases be accounted in the same way?
- How should options and contingent rentals be treated?

EFRAG
European Financial Reporting Advisory Group

Other concerns

- Leases of intangible assets
- Short-term leases
- Sale and leaseback transactions

What is a lease?

- What did the ED say?
  - The ED maintained the same definition as in IAS 17.
  - Entities should identify leases based on the two criteria:

The arrangement involves a <u>specified asset</u>

AND

The arrangement convey the <u>right to control the use</u>

What is a lease?

- What were the concerns?
  - The criteria may capture arrangements that in substance are services.
  - The criteria in IFRIC 4 are unclear and raise common application issues.

What is a lease?

Specified asset = explicitly or implicitly identified

- The underlying is a whole asset or a physical portion
- The supplier does not have a substantive right to replace

Right to control the use of the underlying

- The customer has the ability to direct the use
- The customer obtains substantially all the benefits
- The asset is separable from the services

The arrangement contains a lease

EFRAG
European Financial Reporting Advisory Group

Are all leases the same?

- What did the ED say?
  - *Lessees* should recognise a purchase of a right-of-use asset (RoU) and a liability to make lease payments.
  - At inception, the RoU and the liability are measured at the present value of future payments.
  - The liability is subsequently measured at amortised cost.
  - The RoU is subsequently amortised using IAS 38 (normally on a straight-line basis).

Are all leases the same?

- What were the concerns?
  - Not all leases are financing transactions.
  - The accounting treatment front loads expenses.

Are all leases the same?

LIABILITY				RIGHT OF USE			
Opening	Interest	Payment	Closing	Opening	Amort	Closing	P&L
476.65	33.37	(100.00)	410.02	476.65	79.44	397.21	112.81
410.02	28.70	(100.00)	338.72	397.21	79.44	317.77	108.14
338.72	23.71	(100.00)	262.43	317.77	79.44	238.33	103.15
262.43	18.37	(100.00)	180.80	238.33	79.44	158.88	97.81
180.80	12.66	(100.00)	93.46	158.88	79.44	79.44	92.10
93.46	6.54	(100.00)	-	79.44	79.44	-	85.98

Are all leases the same?

- What has been done?
  - Acknowledgement that not all leases are financing transactions.
  - A dual model to differentiate between finance and other-than-finance (OTF) leases.
  - Distinction based on current guidance in IAS 17 (exposure to risks and rewards).
  - All leases are recognised on the balance sheet.
  - OTF leases, the recognition of the total cost (interest expense + amortization) is straight-line over the lease term.

Are all leases the same?

LIABILITY				RIGHT OF USE			
Opening	Interest	Payment	Closing	Opening	Amort	Closing	P&L
476.65	33.37	(100.00)	410.02	476.65	66.63	410.02	100.00
410.02	28.70	(100.00)	338.72	410.02	71.30	338.72	100.00
338.72	23.71	(100.00)	262.43	338.72	76.29	262.43	100.00
262.43	18.37	(100.00)	180.80	262.43	81.63	180.80	100.00
180.80	12.66	(100.00)	93.46	180.80	87.34	93.46	100.00
93.46	6.54	(100.00)	-	93.46	93.46	-	100.00

Are all leases the same?

LIABILITY				RIGHT OF USE			
Opening	Interest	Payment	Closing	Opening	Amort	Closing	P&L
443.78	31.06	-	474.84	443.78	68.94	374.84	100.00
474.84	33.24	-	508.08	374.84	66.76	308.08	100.00
508.08	35.57	(150.00)	393.65	308.08	64.43	243.65	100.00
393.65	27.56	(150.00)	271.20	243.65	72.44	171.20	100.00
271.20	18.98	(150.00)	140.19	171.20	81.02	90.19	100.00
140.19	9.81	(150.00)	-	90.19	90.19	-	100.00

How should options be treated?

- What did the ED say?

  OPTIONS TO EXTEND OR TERMINATE

  - Amounts due under renewal options should be included based on the longest lease term more likely than not to occur.
  - This is different from IAS 17, that requires including those amounts only when the exercise of the option is reasonably certain.

How should options be treated?

- What did the ED say?

  OPTIONS TO PURCHASE

  – A lease that includes a bargain purchase option should be treated as a purchase
  – Other purchase options should be ignored until exercise.

How should options be treated?

- What were the concerns?
  - Amounts due under options are not liabilities.
  - Options should receive the same accounting treatment.
  - Options should be separately recognised and measured.
  - Assessment of “more likely than not” difficult and creates volatility on the balance sheet.

How should options be treated?

- What has been done?
  - The Boards now require recognition of amounts due under renewal and purchase options only when they create a significant economic incentive for the holder.
  - A significant economic incentive may exist because:
    - The rentals in the optional period are at favorable 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.

How should contingent payments be treated?

- What did the ED say?
  - Contingent payments should be included in the measurement of lease assets and liabilities.
  - Contingent payments should be measured using an expected value approach, and remeasured subsequently.
  - This is different from IAS 17, that <u>excludes</u> contingent payments from minimum lease payments.

How should contingent payments be treated?

- What were the concerns?
  - Amounts due under certain types of contingent payment arrangement (based on usage or performance) are not liabilities.
  - These amounts often cannot be reliably measured.
  - Expected value approach is complex and creates volatility

How should contingent payments be treated?

- What has been done?
  - The Boards now require recognition of contingent payments only if:
    - The payments are contingent on a future rate or index; or
    - The payments are in-substance fixed minimum payments.

Leases of intangible assets

- What did the ED say?
  - Leases of intangible assets are excluded from scope.
  - IAS 17 excludes from its scope only leases of certain intangible assets.

Leases of intangible assets

- What were the concerns?
  - There is no conceptual reason to exclude leases of intangible assets from the scope.
  - Contracts that include leases of both tangible and intangible assets would have to be separated.

- What has been done?
  - The Boards tentatively decided that leases of intangibles are not required to be accounted for in accordance with the leases standard.

EFRAG
European Financial Reporting Advisory Group

Short-term leases

- What did the ED say?
  - Lessors may elect not to apply lease accounting to short-term leases.
  - Lessees may elect not to discount the liability and the right of use asset.

Short-term leases

- What were the concerns?
  - No real relief for lessees.
- What has been done?
  - No change for lessors.
  - Lessees will be allowed to elect not to account for assets and liabilities arising from short-term leases.
  - The election must me made for each category of underlying assets.

Sale and leaseback transactions

- What did the ED say?
  - In a sale and leaseback (S&LB) the parties must assess if the first part qualifies as a sale.
  - If it does not qualify as a sale, the transaction is a borrowing.
  - If it qualifies as a sale:
    - the lessee should derecognise the asset <u>in full</u> and recognise the RoU and liability arising from the leaseback;
    - The lessor should recognise the asset and a receivable, and apply PO approach to the leaseback.

Sale and leaseback transactions

- What did the ED say?
  - If the sale consideration or the rentals due in the leaseback term are not at fair value:
    - The seller/lessee should adjust the RoU and the gain.
    - The buyer/lessor should adjust the underlying asset and the lease liability in the PO approach.

  - The proposals were different from IAS 17, which requires deferral of the gain made by the seller/lessee if the leaseback is a finance lease.

Sale and leaseback transactions

- What were the concerns?
  - There should be no additional criteria to assess if the first part of the transaction is a sale.
  - The lessee should derecognise only a portion of the asset.
  - The lessor should only recognise the residual asset.

Sale and leaseback transactions

- What has been done?
  - The criteria in the Revenue Recognition Standard should be applied to assess if the first part of the transaction is a sale.
  - The Boards required that the final Leases standard is applied to the leaseback part of the transaction.

And for the lessors?

- What did the ED say?
  - *Lessors* should apply a dual approach based on exposure to risks and benefits.
  - When the risks and benefits are transferred, the lessor would derecognise a part of the asset and recognise a receivable (so called *derecognition approach).*
  - If not, the lessor would maintain the asset, recognise a receivable and a lease liability for the same amount (so called *performance obligation approach).*
  - The lease liability is accreted over the lease term.

And for the lessors?

Book value of the asset	600,000
Fair value of the asset	800,000
Expected value of the residual	100,000
Lease period in years	5
Interest rate	7%

	PO approach		Derecognition approach	
PPE	600,000		53,474	
Lease receivable	728,701		728,701	
Lease liability		728,701		-
Gain in P&L		-		182,175

And for the lessors?

- What were the concerns?
  - The performance obligation (PO) approach is inconsistent with the notion that the lease is executed when the lessor gives access to the underlying asset.
  - The PO approach grosses up assets and liabilities and creates application issues relating to impairment calculations.
  - The dual approach is inconsistent with the single accounting approach for the lessees.

And for the lessors?

- What has been done?
  THE BOARDS HAVE NOT COMPLETED REDELIBERATIONS ON LESSOR ACCOUNTING
  - Dual model for lessors still confirmed. Distinction to be made using the same criteria as for lessees.
  - The Boards will consider accretion of the residual or fair value accounting in the derecognition approach.
  - The Boards will consider net presentation in a PO approach, or operating lease accounting. Gross presentation in a PO approach has been dropped.