

## **EFRAG-ASCG outreach event**

### **Main projects of IASB Revenue Recognition, Leases, Financial Instruments and Insurance Contracts**

**– Minutes –**

***Date and venue:***

9 May 2011, Steigenberger Airport Hotel, Frankfurt

***Participants on the panel:***

Liesel Knorr (GASB, president)  
Dr. Elke König (IASB, Board member)  
Dr. Gabi Ebbers (EFRAG, TEG member)  
Dr. Friedrich Siener (EFRAG TEG member)  
Dr. Carsten Zielke (EFRAG, TEG member)  
Chiara del Prete (EFRAG, project manager)  
Rasmus Sommer (EFRAG, project manager)

Liesel Knorr welcomed all participants to this outreach event held by EFRAG in cooperation with the Accounting Standards Committee of Germany (ASCG) and outlined the objectives as well as the planned schedule of this event.

#### **Revenue Recognition**

EFRAG staff presented the proposals contained in ED/2010/6 Revenue from Contracts with Customers that have raised the most concerns among European constituents and the tentative decisions the IASB and the FASB reached during their re-deliberations on these issues.

With regard to the tentative decisions on identifying separate performance obligations one participant pointed out that the necessary assessment of all of the different criteria would be costly and time-consuming. Another participant felt that another step is necessary to determine the accounting outcome depending on whether the integrated service provided by an entity results in a good or a service, because in case of a good the continuous transfer of control is not clear (similar to current IFRIC 15).

In applying the percentage of completion method participants anticipated difficulties with customer acceptance clauses. A member of the German Accounting Standards Board (GASB) believed that contracts for work and services (“Werkvertrag”) in accordance with the German commercial code will not qualify for using the percentage of completion method. Another GASB member said that the tentative decisions are not a step forward for the software industry, because developed software always represents an asset with alternative use for the de-

veloper. Another participant requested more guidance on how a customer can control work-in-progress.

The decisions on royalties were appreciated by the participants because they lead to consistency with internal management and reflect risks and rewards. A GASB member inquired whether cash discounts should be treated in the same way. The IASB member replied that this had not been the intention and announced a corresponding clarification in the final document.

With regard to the consideration of the time value of money a participant indicated a necessary alignment with financial instruments accounting to ensure that discounting is also considered in the corresponding receivable in cases where the time value of money is considered because the contract includes a significant financing component.

The tentative decisions on customer credit risk were perceived as an improvement compared to the proposals in the exposure draft. However, one participant suggested to include a rebuttable presumption (similar to the decisions on time value of money and warranties) not to include customer credit risk, i.e. if the credit risk is reflected in the pricing it should be considered in determining the revenue figure. According to a TEG member the tentative decisions are appropriate from a user perspective.

Permitting the residual method in estimating highly variable stand-alone selling prices was seen as a step in the right direction. As a final step, further guidance is needed in cases in which two or more elements have highly variable prices.

The decision to use the most likely amount to determine the consideration when this will not be reflected by the weighted-average amount was supported by the participants. A GASB member pointed out conceptual discrepancies with decisions taken in the leases project.

With regard to the question of re-exposure the IASB member pointed out that this decision will be made at the end of the re-deliberations but made clear that in any case a staff draft will be published to see the whole picture for purposes of a fatal flaw review.

## **Leases**

For the issues to be discussed an EFRAG TEG member presented the proposals contained in ED/2010/9 *Leases*, related concerns raised in the comment letters and the current status of the re-deliberations by the IASB on these issues as indicated in the presentation materials for the outreach event. The discussions on these issues are summarised in the following.

### *Definition of a Lease*

#### *Introducing Finance Leases and other-than-finance Leases*

A participant of the event fully supported the IASB's acknowledgement that not all leases are financing transactions. However, the conclusion drawn by the IASB to introduce two different types of leases (*Finance Leases (FL)* and *other-than-finance Leases (OTFL)*) indicates that the future lease accounting requirements for lessees may be rather more similar to the current guidance in IAS 17 than to what had been proposed in the ED. In the light of one of the overarching goals of the lease project, to abandon the dichotomous structure of IAS 17, it would rather make sense to keep the current standard for leases and not change anything. In

this context a GASB member objected to the dichotomous approach (FL and OTFL) as proposed by the IASB, since it was the intention of the lease project to get rid of an approach based on two different types to account for leases. Since for short-term leases a simplified approach will be allowed, it appears reasonable and acceptable to apply the accounting treatment as proposed in the ED to all remaining leases. It further may be questionable to deny that lease contracts with a lease term in excess of twelve months are financing transactions. Another participant of the event preferred to stick to the proposals in the ED due to a cost / benefit analysis with respect to necessary system adaptations allowing the amortisation of the right of use (RoU) asset to be amortised based on a pattern inverse to the effective interest rate method. Further, another participant of the meeting observed that the structuring opportunities under IAS 17 with respect to the balance sheet based on the proposed approach will only be transferred to now focus on the income statement.

The presenting EFRAG TEG member pointed out that one of the significant differences between IAS 17 and the proposed new accounting requirements for leases justifying the introduction of a new lease standard is the recognition of all assets and liabilities arising under leases. Additionally, based on the guidance provided by IAS 17 many users of financial statements adjust the amounts presented in the statements of financial position to reflect the assets and liabilities arising from operating leases – that would not be necessary under the accounting guidance as proposed. With respect to the structuring opportunities it should be considered that these opportunities will be significantly reduced compared with the possibilities under IAS 17.

The IASB member disagreed with the above mentioned conclusion that the guidance in IAS 17 is 'pretty much the same' as the differentiation into FL and OTFL.

With respect to the proposed accounting treatment for OTFL, according to which the recognition of the total cost is straight-line over the lease term (and the amortisation of the RoU asset increases over the reporting periods), some participants of the meeting did not have an issue. The presenting EFRAG TEG member stated, once the straight-line approach has been accepted, the 'matching part' to get to equally distributed net lease expenses over the lease term should rather be the amortisation of the RoU asset than the interest on the lease liability (since otherwise meaningless financial ratios will be generated for a company's financing situation). A representative of the leasing industry proposed to implement a linked approach to subsequent measurement for all leases as it was proposed in the DP *Leases – Preliminary Views*. On that basis, the combined treatment of the RoU-asset and the liability to make lease payments must be viewed as an integrated accounting approach, which would be unique for leases or in other words: a case sui generis. A GASB member did not support the straight-line approach from a conceptual point of view and highlighted that impairment issues would become more relevant.

The IASB member commented that she would not support the linked approach. She further reported that the IASB discussed but dropped the following approaches: FL represent financed purchases which shall be accounted for following the proposed standard on *Revenue from contracts with customers* and IFRS 9 with no specific lease standard necessary. For OTFL on the other hand, a lease standard would be necessary and the 'matching part' to get to equally distributed net lease expenses over the lease term ('the plug') should be posted to OCI.

### *Treatment of options*

The first question coming from the audience inquired about varying significant economic incentives over time. How shall the proposed treatment be applied and must it be applied at the inception of the lease only? In the course of the following discussion various views were presented and indicated, that this area clearly needs further specification (application only at the outset of the contract or regularly in the following reporting periods; what criteria (indicators) must be met in order to readdress this issue in later reporting periods, ....).

Another participant inquired about the required treatment for agreed leases without an expiration date for the contract, but which may be cancelled at any given time with a notice period of one year or less, so that the lease may end after a term of twelve months or less after the commencement of the lease. This type of contract is common in Germany, as an example, for regular rental agreements such as renting office space or warehouses. The IASB member confirmed that this type of leases is not common in Anglo-Saxon countries and the issue will be brought to the IASB's attention.

### *Treatment of contingent leases*

First the question was posed how to account for a change in an index subsequent to the initial measurement (e.g. in case the lease for a building would be linked to the inflation rate)? According to the response provided the adjustment would be treated with effect to the income statement<sup>1</sup>.

Additionally, in this context a GASB member had identified different approaches to be applied under the proposed new standards on *Revenue from contracts with customers* and on *Leases* and inquired whether the IASB intends to harmonise the guidance. The IASB member confirmed that this is the Board's intention. Such a review on cross cutting issues is scheduled to be one of the last duties to be performed by the Board – it will possibly be done in the course of the final drafting of the new standards.

### *Leases of intangible assets*

A participant stated his concerns about scoping out intangible assets from the scope for conceptual reasons. Some of the GASB members stated that they support the exclusion of intangible assets until the IASB has considered the accounting for intangible assets more broadly (for example the question whether non-exclusive licenses can represent 'specified' assets in the meaning of 'explicitly or implicitly identifiable').

### *Short-term leases*

#### *Sale and leaseback transactions*

No issues were brought forward.

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<sup>1</sup> In opposition to the response provided in the meeting, the accounting treatment may actually need to follow the guidance in ED.18: "A lessee shall distinguish changes in contingent rentals ... that relate to current or prior periods from those that relate to future periods. A lessee shall recognise changes in the expected amount of such payments: (a) in profit or loss, to the extent that those changes relate to current or prior periods. (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future periods. ..."

### *Lessor Accounting*

The IASB member confirmed that there is still a majority in the Board for addressing both lessee and lessor accounting in the new standard on leases.

Several participants expressed their preference for only one accounting model for lessors. This accounting model should be the derecognition approach since the performance obligation approach is considered to be conceptually impaired. However, the IASB member made clear that this is rather unlikely to happen; the Board is likely keeping its approach of introducing both models, the derecognition approach as well as the performance obligation approach. However, no decisions have been taken yet and the Board will continue its re-deliberations later in May.

One participant strongly encouraged the IASB to require accretion of the residual in the derecognition approach since - from a business point of view - this approach is absolutely essential.

### *Other issues*

A representative of the leasing industry made reference to the preliminary decision taken by the Board at its 21-23 March meeting with respect to separating lease and non-lease components of a contract. In allocating payments between the lease and non-lease components of the contract, the lessee should account for all the payments required by the contract as a lease in case there are no observable purchase prices. This proposed treatment is considered a severe punishment for lessees.

At the end of the leases sessions the IASB member confirmed that the Board is aware that it needs to decide whether it will be necessary to expose its revised proposals for public comment ('re-exposure'). The effective date for the new standard would be 2013 at the very earliest.

## **Financial Instruments**

### *Classification and Measurement*

EFRAG staff initially provided an update of the project plan while commenting it being optimistic, in particular with respect to a possible re-exposure of the classification and measurement requirements due to the FASB's current deliberations that, in EFRAG's view, might re-open phase 1.

The GASB mentioned that the FASB's deliberation of (and changes on) its classification and measurement model does not necessarily change the IASB's model, and that IFRS 9 phase I is already applicable in a number of jurisdictions. However, EFRAG repeated two of its major concerns regarding IFRS 9, which are the different treatment of embedded derivatives on both sides of the balance sheet and the presentation of fair value changes for equity instruments in OCI without recycling.

The public asked for EFRAG's view on the endorsement of IFRS 9. EFRAG stated that it would not propose endorsement until the current concerns as well as the macro hedging issue – on which no proposals have been exposed by the IASB so far – are solved. Endorse-

ment advice is only developed upon official request by the EU commission. A representative of the EU commission replied that from the commission's point of view IFRS 9 does not seem to be satisfactory yet, and that convergence is not achieved; therefore, the commission is not yet in the position for requesting endorsement advice. As an alternative to endorsing IFRS 9, the commission might propose to maintain IAS 39.

GASB members urged all parties involved in the endorsement process to closely follow the development of phases two and three with a view of embarking on formulating the endorsement advice upon completion of these phases. Deferring the endorsement discussion until macro hedging proposals are completed is seen as inappropriate; thousands of listed entities in the corporate sector should be able to benefit from the currently proposed improvements to hedge accounting.

The IASB member pointed out that the board itself had always planned to review the final outcome of replacing IAS 39 when all the phases are completed. Further, the phased approach had been adopted rather because of political pressure (in particular for phase 1), and the results of phase 2 and 3 would be finalised very soon.

#### *Impairment*

EFRAG introduced the joint proposals of IASB and FASB in the supplementary document. EFRAG considered the proposals in the original exposure draft to be more appropriate. The IASB member as well as the GASB agreed that methodically those proposals were superior, but a compromise had to be sought because of the different starting points in the IASB's and FASB's proposals. Accordingly, the supplementary document provided a solution meeting the needs of both boards as well as the practicability concerns of their constituents.

However, both EFRAG and the IASB member mentioned that some requirements such as the straight-line allocation over time or the treatment of short-term receivables could be re-considered and maybe modified. In general, EFRAG and GASB seemed equally supportive.

#### *Hedge Accounting*

EFRAG supported the hedge accounting proposals, in particular the objective. However, EFRAG urged the IASB to propose how to treat dynamic portfolio hedge accounting soon, and made clear that until proposals on dynamic portfolio hedges are exposed it would not finalise its assessment of the current proposals.

The representative of a financial institution commented that the objective of bringing hedge accounting in line with risk management is inappropriate and would rarely be met, as hedge accounting requirements do not permit to depict all risk management strategies. GASB shares that concern: The GASB considers the objective of hedge accounting to be avoiding accounting mismatches. Basically, risk management considers cash flows while hedge accounting considers recognised items – with each providing a bundle of cash flows –, which are very different starting points. The representative of a banking federation agreed with this view; if hedge accounting is applied it should be close to risk management, but risk management activities should not necessarily require hedge accounting in any case in a similar way. The IASB member agreed with the view the focus was not whether hedge accounting equals the risk management activities, but to the extent possible.

The IASB member and the GASB pointed out that the current hedge accounting proposals are a very important step forward for corporate entities, but not only for those. This should be borne in mind when considering the needs (portfolio hedges) of financial institutions with a particular business model (core deposits).

## **Insurance Contracts**

For the issues to be discussed an EFRAG TEG member presented the proposals contained in ED/2010/8 *Insurance Contracts*, related concerns raised in the comment letters and the current status of the re-deliberations by the IASB on these issues as indicated in the presentation materials for the outreach event. The discussions on these issues are summarised in the following.

*Volatility issue under the proposed model*

*Unlocking the residual margin*

*Presentation*

- *Summarised margin approach combined with volume information*

First the IASB member summarised the IASB's discussions and preliminary decisions on the captioned subjects over the last four months (in this respect please refer to the related IASB Updates).

A participant of the meeting required appropriate time for the constituents to review the preliminary decisions taken by the IASB before they will be finalised since the decisions relate to complex and interrelated issues. The IASB member assured that the Board will provide such time also considering that more preliminary decisions will be taken in May and June before the drafting of the standard will be resumed by the IASB staff. Around that time the IASB will also review whether it will be necessary to expose its revised proposals for public comment ('re-exposure').

A representative of EFRAG TEG mentioned the solvency II directive initiated by the European Commission and the issue of considering 'liquidity' in this context.

A member of the GASB listed preliminary decisions taken by the IASB which are perceived in a positive way (the proposed point in time for recognition; acquisition costs ('incremental') – now also treated on a portfolio level; option to apply either a 'bottom-up' or a 'top-down' approach to determining discount rates; the transition requirements and the alignment of the effective dates for IFRS 9 and IFRS 4 (rev.) for insurers). On the other hand, the IASB's preliminary decision not to lock-in the residual (composite) margin at inception is not supported. Still subject for decisions to be taken are the so called "OCI-approach" under IFRS 4 and the presentation issues for insurance contracts.

A participant of the meeting asked why it will not be permitted to base the residual margin on estimates. The attending board member confirmed that the IASB will reconsider this issue after the FASB has asked its constituents on this issue. But there would be no "pick and choose" approach. In this context it was confirmed once more that on the issues 'residual margin' and 'unlocking' no decisions have been taken yet.

A member of the EFRAG TEG specifically challenged the summarised margin approach combined with volume information, which may be seen as a requirement to provide that type

of information twice. From the audience it was replied that the IASB should downsize these requirements in order to compromise on this challenging presentation issue. The 'double presentation' would be a challenge for operational units and deriving that information from existing IT-reporting tools. In general it was proposed to keep the presentation requirement rather short and simple but faithful and prudent at the same time.

Further, an EFRAG TEG member proposed to clearly define the terms 'premium' and 'revenue' for insurers including personal insurance companies ("*Personenversicherer*").

#### *Presentation*

##### *- Presentation of volatile changes*

A GASB member commented on the advantages of the OCI-approach, which appears to be the broadest consensus possible. In the balance sheet all current assumptions would be reflected, while the profit and loss of the period would not be affected by inappropriate interest rate fluctuations. An EFRAG TEG member proposed that in the given context the exasperating issue of stock price gains and losses should be addressed and solved as well.

Other GASB members noted that an appropriate conceptual basis for presenting items in OCI has not yet been provided by the IASB. On that basis there appears to be a risk that OCI is used as sort of a 'dumping ground' for items which are banned from being presented in profit and loss. Therefore, the OCI-approach as mentioned above rather appears to be a 'quick-fix' than a sustainable long-term solution. Further, if for insurers the OCI-approach may be implemented, the appetite of other industries may be whetted for similar solutions to their issues.

The IASB member confirmed that discussions in this direction have been started and are under way.

#### *Modified approach for short-duration contracts*

While an EFRAG TEG member highlighted the importance of clarifying the guidance in ED.54 (a), according to which the coverage period of the insurance contract is approximately one year or less, the IASB member pointed out that further criteria need to be met as well and that discussions on this issue by the Board just started.

#### *Transition requirements*

The IASB member emphasised that a further discussion of this issue would not be very helpful before all other issues in the given context have been addressed and solved.

#### *Other issues*

A panel member inquired the reasoning to scope out financial guarantees from the future standard on insurance contracts. The IASB member responded that the issue had been discussed in April without identifying an appropriate solution. Therefore the current guidance has been confirmed (if a bank enters into such a contract, it shall account for it in accordance with IFRS 9). This is because banks will not be required to apply the standard for insurance contracts just for financial guarantees issued.

Another panel member inquired about the understanding and definition of the term 'portfolio' in the context of the ED, specifically with respect to size-related limitations and the level of diversification permitted. The IASB member responded that the Board has not yet discussed this issue – however, portfolios shall be understood as cohort levels that adequately group insurance contracts.

Finally, the following question was raised: on the one hand it is the IASB's intention to require insurers to apply IFRS 9 and the new standard on insurance contracts as per the same effective date. However, in case an insurer is a group company of a bank, the insurer may be required to apply IFRS 9 earlier than the new standard for insurance contracts. The IASB member responded that this scenario is rather unlikely to occur since the current best estimate is that according to the big bang approach the number of new IFRSs it expects to issue in 2011 should become effective as per 2015. However, the remaining risk in that context may be that the finalisation of the standard on insurance contracts takes longer than this anticipated effective date.

Berlin, 9 May 2011