



# IFRS news

## Leases – another nail in the coffin for convergence?

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**The IASB and FASB again show signs that convergence is no longer a priority when discussing the next steps of the Leasing project.**

One would be forgiven for thinking that the IASB / FASB redeliberations of the leasing project in March were aimed to achieve a converged solution. The two Boards sat in the same room, but came to very different preliminary conclusions on the accounting by both lessors and lessees.

The 640 **comment letters** received expressed limited support for the dual model proposed in 2013. This was the third attempt by the Boards to develop a converged model since they began working on this project in 2006.

Hans Hoogervorst, IASB Chairman, has acknowledged the challenges. He said, “We have been struggling with this standard for many years, for two reasons, I think. First of all, because it’s very controversial: many companies simply don’t like this stuff on the balance sheet. And secondly, because it’s also intellectually challenging. And I agree with all those who say there is no simple answer. It’s not easy to find the right answer.”<sup>1</sup>

### **The latest proposals**

#### **Lessee accounting**

While both Boards agreed that all leases should be recorded on the balance sheet, the income statement will be different.

The IASB decided to pursue a single income statement approach for all leases. The lessee will account for all leases (except for leases with a term of less than 12 months and

small ticket leases) as finance (Type A) leases. This would result in a front loaded expense for all leases, similar to finance lease accounting today.

The FASB, however, decided to pursue a dual approach with classification as finance (Type A) or operating (Type B) based on the current dividing line in IAS 17 today. Income statement for Type A leases would be the same as the IASB’s approach. For Type B leases, expense would be recognised on a straight line basis similar to operating leases today.

FASB member Daryl Buck said this approach is the simplest and most direct answer to the project’s objective of recording all lease liabilities on the balance sheet in the least disruptive way possible for preparers. Whilst Hans Hoogervorst said that the all-Type A approach is the most conceptually sound model.

This is a straightforward clash between conceptual simplicity (the IASB view) and practical expediency (the FASB view). One thing that is certain is that the May 2013 proposals are dead.

#### **Lessor accounting**

Neither board showed any appetite to move away from the current lessor model. However the FASB has decided to put a constraint on the recognition of selling profit or revenue for sales type leases based on the guidance in the soon to be published

<sup>1</sup>IASB FASB Joint Board Meeting, March 2014

converged revenue recognition standard. The IASB did not agree to such overlay. There is a commonly held view that lessor accounting in IAS 17 is not broken. Maybe the answer is not to change it.

**What is next?**

Deliberations will continue in the coming months and it's not clear what the final outcome will be.

## **IFRS 10 – Have you lost ‘control’?**

**Derek Carmichael, secretary of PwC’s Consolidation working group, looks at the challenges associated with the assessment of control under IFRS 10.**



IFRS 10, the new consolidation standard applicable from 2013, has brought clarification to a number of areas important to the assessment of control. For example, it provides definitions of relevant activities and guidance on how to assess power when there are multiple investors who each have the ability to direct different activities.

a manufacturer has sold an asset to a structured entity (the ‘SE’). The manufacturer provides a guarantee over the residual value of the asset. The SE funds the purchase with a loan from a bank and leases the asset to a third party. The term of the lease is for 20 years and the life of the asset is 25 years.

That said, focus on the investor currently having the ability to direct relevant activities may have created an unexpected problem. It has raised the question about whether control can change over time.

The relevant activities of the SE are assessed as being the management of the lease receivable, and the decision on how to realise the residual value of the asset at the end of the lease. The agreement provides the bank with power over the lease receivable activity and the manufacturer with power over the residual value decision.

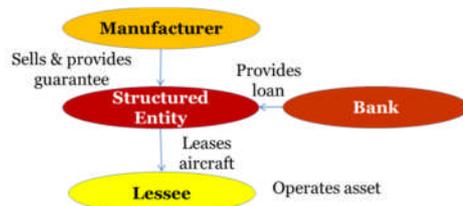
IFRS 10 explains that, where two or more investors have the ability to direct different activities and those occur at different times, the investor who can most significantly affect returns will be considered to have power. The standard also mentions the importance of considering purpose and design. This suggests the planned allocation of decision-making rights over the entire life of an arrangement be considered. But what does this mean in practice?



The standard emphasises the importance of current decision making rights. However, this might be inconsistent with the need to also consider the decision-making rights over the entire life of an arrangement in instances where different activities occur at different points in time.

If cash flows expected to result from the lease receivable are more significant than the residual value in year 1, the bank might be seen as having power and would likely consolidate. But how does that assessment change over time?

Consider the following scenario:



In year 19, only one year of the lease remains. The return of the SE can still be affected by the management of the lease receivable, however now the residual value of the aircraft is assessed as being greater than the remaining lease receivable.

If there has been no other change in facts and circumstances, would the bank still be viewed as having control? Or will the manufacturer's increased ability to affect the remaining returns mean the bank has lost control?

*Can the passage of time alone result in a change in control?*

Some might say there cannot be a loss of control if there has been no change in facts and circumstances. The guidance in the standard on having "the current ability...to direct the activities that most significantly

affect those returns" challenges this view. But if passage of time alone was something that could change the control assessment, would this require a reassessment at each period end? If not, when should the reassessment be performed?

The tension between the need to consider the overall design of an arrangement and simultaneously assess the current ability to direct activities requires judgement to be applied. Finding the correct balance is an unexpected area of complexity introduced by the standard. As with any new standard, practice will evolve in this area.

## OCI – is it here to stay?

**The verdict is in...investors and preparers continue to support a subtotal in the income statement. But can the IASB develop a consistent principle for determining what goes into OCI and, more importantly, whether and when it is recycled?**

The IASB has now taken its first look at the feedback from over 200 comment letters received in response to the Discussion Paper on the Conceptual Framework. The response shows clear support for the continued use of OCI, but a number of questions remain.

First up is the question about how to define performance. Although respondents agree with a profit or loss subtotal, they are not looking to define OCI and treat profit and loss as the residual. There are also mixed views on recycling. Many insist that the IASB should further describe profit or loss as a performance measure.

Let's look at recent example. IASB member Patricia McConnell recently shared [her view](#) on the IASB's decision that changes in own-credit risk should be recognised in OCI. She noted that the change meant investors would no longer need to make an adjustment and called it "good news for the investment community<sup>2</sup>."

But what other adjustments are investors looking to avoid and how does that relate to OCI? Most agree that a single definition of performance would go a long way to tackle these issues but is this a realistic goal? No decisions have been made yet but it is clear that OCI will continue to spark debate.

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**Global valuations standards - are they achievable?** PwC Global valuations leader John Glynn and director Caroline Woodward explain how global valuation standards are worth pursuing, regardless of the obstacles likely to be encountered en route. With a new chairman in place at the IVSC, the time could be right.

**IFRS - just how standardised is it?** Nearly 10 years after IFRS became mandatory in the EU and Australia, how consistent has the world been in its interpretation of the standards? Christopher Nobes, Professor of Accounting at the Universities of London and Sydney, takes a look.

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<sup>2</sup>Investor Perspective – One fewer non-GAAP adjustment to worry about: improvements to the accounting for changes in own credit March 2014

## Cannon Street Press

### *EU backs IFRS foundation*

The European Parliament voted to continue financing the IFRS Foundation, European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB). The regulation proposes annual contributions of approximately 4.3 million euro to the IFRS Foundation (17% of its budget), 3.4 million euro to EFRAG (43% of its budget) and 0.3 million euro to PIOB (22% of its budget).

The financial support for the IFRS Foundation covers the period from 2014 to 2020. The decision is seen to confirm the

EU's continued support for IFRS as a single set of globally accepted accounting standards. That said, the final approval came in the face of last minute concerns expressed about the IFRS Foundation's governance structure.

The financing for EFRAG is limited to three years pending implementation of reforms recommended by the independent review led by Philippe Maystadt. The report on this independent review was issued in late 2013 as the first step in a broader debate about the future of the governance structure.

### *Exposure draft on IAS 1 narrow scope amendments*

The IASB issued an exposure draft on amendments to IAS 1 (the 'ED') as part of its Disclosure Initiative. The deadline for comments is 23 July 2014. The following is a summary of some of the proposed amendments.

#### *Materiality*

An entity should not aggregate or disaggregate information in a manner that obscures useful information, for example, by aggregating items that have different characteristics or disclosing a large amount of immaterial detail.

When management determines an item is material, the ED requires assessment of which specific disclosures set out in the relevant standard should be presented, and whether additional information is necessary to meet the needs of users of financial statements or the disclosure objectives of that standard.

#### *Disaggregation and subtotals*

The proposals address additional subtotals in the statement of financial position or the statement of profit or loss and other comprehensive income. The ED specifies what additional subtotals are acceptable and how they are presented. The proposed guidance captures common subtotals that

are not specifically required by IFRS, such as operating profit or profit before interest and tax. Additional subtotals should be:

- made up of items recognised and measured in accordance with IFRS;
- presented and labelled in a manner that makes the components of the subtotal understandable; and
- consistent from period to period.

The ED requires that an additional subtotal in the statement of profit or loss and other comprehensive income should not be displayed with more prominence than the subtotals and totals specified in IAS 1. Additional subtotals must be reconciled to the subtotals and totals required by IAS 1.

#### *Notes*

Management should consider the understandability and when it determines the order of the notes. An entity is not required to present the notes to the financial statements in a particular order. An entity might, for example, present more significant notes first or present linked areas sequentially. Such flexibility, which is already permitted by IAS 1, may allow for management to provide further insight about the entity.

### *Disclosure of accounting policies*

The ED clarifies how to identify a significant accounting policy by removing unhelpful examples from IAS 1. The IASB recognises that additional work is required as part of the Disclosure Initiative on determining and disclosing significant accounting policies.

### *OCI arising from investments accounted for under the equity method*

The ED requires that the share of other comprehensive income arising from investments accounted for under the equity method is grouped based on whether the items will or will not subsequently be reclassified to profit or loss. Each group should then be presented as a single line item in the statement of other comprehensive income.

## **Narrow scope amendments for joint arrangements**

The IASB decided to move back the implementation date of two narrow scope amendments to 1 January 2016. The two amendments focusing on the accounting for joint arrangements are:

- IFRS 11: Acquisition of an interest in a joint operation - see [straight away 104](#) for further details.
- IFRS 10 and IAS 28: sale or contribution of assets between an investor and its associate or joint venture - see [straight away 103](#) for further details.

Publication of the final amendments is expected in the second quarter of 2014.

The IASB also discussed a potential inconsistency created within IAS 28 by the amendments noted above. The inconsistency relates to the level of gain/loss recognition when an entity makes a contribution to an associate or joint venture and receives assets or cash in addition to an equity interest.

The IASB will propose an additional amendment to IAS 28 with an objective to clarify this inconsistency. This proposal will be included in a separate Exposure Draft on the elimination of gains from 'downstream' transactions. The ED is also expected in the second quarter of 2014.

## **Equity accounting in separate financial statements**

The IASB discussed feedback on the proposed amendment to IAS 27 to allow the equity method as one of the options to account for an entity's investment in subsidiaries, associates or joint ventures in its separate financial statements. The IASB received 60 comment letters which

expressed general support for inclusion of the equity method. The IASB will address the more detailed concerns raised by respondents including the consequential amendment to IAS 28 and transition at their next meeting. The final amendment is expected later in the year.

## **Practical guide to new IFRSs for 2014**

This [publication](#) outlines the new IFRS standards and interpretations that come into effect for 2014 year ends. Four amended standards and one new interpretation are mandatory for entities outside the EU for 2014 year ends. Within the EU, IFRSs 10, 11 and 12 and related amendments also become mandatory for 2014 year ends. A number of other revisions including the annual improvements for 2012 and 2013 are effective from 1 July 2014 although can be adopted early. Hard copies can be ordered from [ifrspublicationsonline.com](http://ifrspublicationsonline.com).



## ***Know your IFRS ‘ABC’: O is for ‘Onerous contracts’***

**Margaret Heneghan from PwC’s Accounting Consulting Services recaps the accounting for onerous contracts.**



What is the accounting when an entity agrees to purchase a good or service? In most cases there is no accounting, at least not until the goods or services are delivered. A liability is generally not recognised for a future obligation. But there’s an exception: where a contract has become onerous, a provision is recognised immediately.

Most think that when a contract becomes ‘onerous’, it’s bad news. Well it might be if you have sold your soul to the devil (see ‘The bit at the back...’ page 8). But we also know that bad news does not always ‘hit’ the financial statements when it happens: tomorrow’s expenses do not usually result in liabilities today.

Let’s explore what makes a contract onerous and how and when obligations under such a contract are measured and recognised.

### ***The basics***

#### ***What’s an onerous contract?***

An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. If a contract is onerous, the present obligation under the contract is recognised and measured as a provision.

Such provisions reflect the unavoidable loss under the contract, that is, the excess of any unavoidable costs over and above the future economic benefits.

#### ***Unavoidable costs***

Unavoidable costs under a contract are the lower of the cost to fulfil or exit the contract.

#### ***Future economic benefits***

Determining the cost to fulfil or exit a contract is often not difficult, but measuring the benefits from a contract can be tricky. This is because the economic benefits expected to be received under a contract are

not restricted to those contractually committed. For example, where an entity abandons a leased property, it takes into account potential rental income from the sub-let in determining the expected economic benefits. The potential income is considered even if a tenant has not yet been identified or the management chooses not to sub-let.

#### ***Future operating losses versus onerous contract***

IAS 37 prohibits the recognition of future operating losses. So, for loss-making activity, an entity recognises those losses as they arise rather than providing for them in advance. But where an entity is ‘locked in’ to making a loss because of a contractual commitment, it considers whether that contract is onerous and if it is, it makes a provision.

### ***Common pitfalls***

#### ***Impairments are recognised first***

Before recognising a provision for an onerous contract, the entity first impairs any assets that are dedicated to the contract. Only if there is still an expected loss after the assets have been fully written down should an onerous contract provision be considered. For example, leasehold improvements or inventory might require write down.

#### ***Unfavourable pricing does not always equal onerous contract***

Contracts are not onerous just because they are priced less favourably than current market alternatives. They might still be part of a profitable activity, albeit less profitable than could be achieved under current market conditions.

#### ***Loss-making does not always equal onerous contract***

Management often elects to continue in a contractual activity that, when looked at

narrowly, seems loss-making. But where an entity continues in a loss-making arrangement, it is normally because there is a wider economic benefit in doing so. Therefore, the related contracts are generally not onerous.

### Example

Let's look at an example.

- An entity has a chain of 10 stores located throughout the country.
- The entity is profitable overall but two stores in one region are loss-making.
- Each store is subject to a 10 year operating lease of which 6 years have elapsed.

Should the entity recognise a provision for future lease payments on the loss-making stores on the grounds that the leases are onerous contracts in the following cases?

#### Case 1 – Plan to close stores

No return to profitability is expected over the remaining lease terms or subsequently. Management plans to close the stores in the next financial year but has made no public announcement to that effect by the end of the current financial year.

*Analysis:* The fact that no closure announcement has been made by the year end means that no provision could be made for termination costs (redundancies etc.). But it would not mean the lease contracts were not onerous.

If the stores are loss-making and are a separate CGU, the entity will first impair any dedicated assets (for example, leasehold improvements). If the stores are still loss-making following any impairment, the entity provides for the difference between the unavoidable costs and the expected economic benefits under the contracts.

The unavoidable costs are the lower of (a) any lease termination charges and costs / losses up to termination date, and (b) future committed lease payments plus the losses up to the business cessation date. The expected economic benefits (such as any expected sub-let rental income after the properties are

vacated by the entity) reduce the amount of the provision.

#### Case 2 – Stores to remain open

Management plans to keep the stores open in the hope that they will return to profitability after the end of the lease term. It also recognises the significant challenges to re-establish future operations in the current locations. Management hopes that over the longer term, future profits will exceed the losses to which it is committed in the next few years.

*Analysis:* The lease contract is not onerous so no provision would be made. For the two stores to access the profits beyond the current lease terms, the entity must bear the costs of the current leases. In other words, access to future profits is a key benefit derived from the current leases. Since it is anticipated that these will exceed the losses to be made during the current lease terms, the lease contracts are not onerous.

Nonetheless, the entity should still evaluate whether the assets dedicated to the contract have been impaired.

#### What does this tell us?

Intuitively, one might think that a contract related to a loss-making activity is onerous; this is not necessarily so. Once the dedicated assets are impaired, it might not be loss-making and even if it is, other factors might tell us the contract is not onerous.

We generally expect an entity to anticipate exit if a contract is onerous. If management plans to continue an arrangement that, on the face of it, is loss-making, it is usually because there is a commercial advantage in doing so. In most cases, this means that the related contracts are not onerous.

In some cases, the unavoidable losses of a contract are minimised by fulfilling the contract. For example, it might be cheaper to operate a loss-making store for the lease period than to abandon the store. Such contracts are still onerous but the provision is based on the amount of losses to the end of the contract.

## The bit at the back....



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