

IFRS news

‘Revenue’ discussions move closer to June deadline

In this issue:

- 1 Update on revenue discussions
- 2 Leasing discussions delay standard
- 3 ‘Revenue’ impact on oil and gas sector
- 4 Interpretation Committee
What’s on the agenda?
- 5 Transition issues
Japan
- 6 Contacts



Guilaine Saroul

The FASB and IASB (‘the boards’) met in March to discuss their joint project on revenue recognition. They reached tentative decisions on collectibility, time value of money, and onerous contracts; they also discussed variable consideration, which will be debated further in April. Guilaine Saroul and Jason Aeschliman from PwC’s Accounting Consulting Services team in the US looks at the key points.

Collectibility

Many respondents disagreed with adjusting revenue for credit risk with subsequent changes reflected in other income or expense. The boards affirmed that collectibility of the transaction price will no longer be a hurdle to revenue recognition as it is under today’s guidance. The boards have now agreed that the transaction price will be presented without adjustment for credit risk. An allowance for expected impairment losses on receivables will be presented in a separate line adjacent to revenue. Both the initial impairment



Jason Aeschliman

assessment and any subsequent changes in the estimate will be recorded in this line.

Time value of money

The boards affirmed that the transaction price should reflect the time value of money when the contract includes a significant financing component. They intend to provide additional factors for when a significant financing component exists to address respondents’ concerns about practical issues. They tentatively decided that, as a practical expedient, an entity will not need to account for the time value of money when the period between payment and the transfer of goods or services is less than one year.

Onerous contracts

Onerous contract losses will be assessed at the contract level, rather than the performance obligation level. This includes contracts that are intentionally priced at a loss, with the

expectation of profits on subsequent contracts (for example, loss leaders). The boards concluded that direct costs should be used to determine whether a contract is onerous. Costs to terminate a contract will not be reflected until the entity is committed to cancelling it. Cancelling the contract may also give rise to other obligations, to be accounted for in accordance with provisions and contingencies guidance. The onerous contract guidance will generally result in earlier recognition of losses compared to today's accounting.

Variable consideration

The ED proposed that the transaction price should reflect an estimate of variable or

contingent consideration if it can be reasonably estimated. Some respondents were concerned about recognising revenue before a contingency is resolved. The boards extensively discussed alternative approaches but did not reach a conclusion. The debate is focused on arrangements common to certain industries where consideration is based on future sales of the customer's products to another party (for example, sales-based royalties) or on an index value in the future (for example, performance-based fees for assets under management). These arrangements are common in certain industries, including pharmaceutical, entertainment and media, and asset management. The boards will continue to redeliberate variable consideration this month.

Next steps

A number of key issues remain to be redeliberated, including variable consideration, allocation of transaction price, contract costs, accounting for licences, disclosure and transition.

The boards are expected to vote on final decisions in June 2011 with a final standard available in the second half of 2011.

'Leasing' discussions delay final standard



Marian Lovelace

The IASB and FASB met three times in March to make tentative decisions on a number of secondary re-deliberation issues. The remaining key re-deliberation issues are due for discussion this month, so the boards will not meet their original 30 June publication deadline. Their revised goal is to publish the new leasing standard during the second half of this year after balloting members in June. All decisions made to date are therefore tentative. Marian Lovelace from Accounting Consulting Services in the UK looks at the details.

Short-term lease accounting

A lessee will be permitted to account for short-term leases in a manner consistent with the present IAS 17 requirements for operating leases. This decision makes the accounting for short-term leases for lessees consistent with that of lessors in the ED and responds to constituent concerns. The short-term lease guidance will be an accounting policy choice made on an asset-class basis.

Guidance on distinguishing a lease from a purchase or sale

The guidance in the ED for distinguishing an in-substance purchase or sale will be removed. As a result, a contract should be accounted for in accordance with the

leasing standard when the definition of a lease is met. Where the definition is not met, the contract should be accounted for in accordance with other applicable standards.

Purchase options

No tentative decision was made, but the boards did give a steer to the staff that the accounting for purchase options should be consistent with their tentative decision on renewal options – that is, should include purchase options in the measurement of lease payments where there is a significant economic incentive such as a bargain purchase option.

Scope

The boards confirmed that the scope of the leasing standard would be the same as in the ED.

Sale and leaseback

A transaction should be accounted for as a sale and leaseback when a sale occurs using the control criteria in the proposed revenue standard (the specific sale criteria in the leases ED has been removed). The sale will be the sale of the whole asset; when consideration for the underlying asset is at fair value, any gains or losses should not be deferred.

Contracts that contain a lease

All non-lease components in a multiple element arrangement, including services and other executory costs, should be separated and accounted for in accordance with applicable guidance. Lessors will be required to allocate all payments in the contract between lease and non-lease components, consistent with an allocation method in the revenue recognition project. Lessees will be required to allocate between lease and non-lease components based on their relative stand-alone purchase price. If the purchase price of only one component is observable, a lessee is permitted to use the residual method to allocate the price to the component for which there is no observable

price. Where there are no observable prices for any components, the entire contract would be accounted for as a lease.

Initial recognition and measurement

A lessee and lessor should only recognise and initially measure lease assets and liabilities at the date of commencement of the lease. This is a change from the ED proposal to measure leases from the date of inception of the lease.

Determining the discount rate

A lessee should use the incremental borrowing rate or the rate the lessor

charge the lessee if readily available, as proposed in the ED. Where both rates are available, the lessee should use the rate the lessor charges the lessee. The lessor should use the rate charged in the lease.

Initial direct costs

The boards confirmed the definition of initial direct costs will be 'costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made', consistent with the proposal in the ED.

Uncertainties over revenue ED's impact on oil and gas industry



Derek Carmichael

Revenue recognition in the oil and gas industry may appear to be a simple process. However, there are common transactions within the industry that could be significantly affected by the proposals in the revenue ED. Derek Carmichael in PwC's Accounting Consulting Services Central Team looks at the detail.

Overlift and underlift

Many entities develop and produce oil and gas within a joint arrangement and share the physical output. The physical nature of lifting means it is often more efficient for each partner to lift a full tanker-load each time, which may not equal its ownership interest. Entities currently account for an underlift (less than entitlement) as revenue from the other partners, and for an overlift (more than entitlement) as a purchase from those partners.

It is unclear whether joint venture partners will meet the definition of a 'customer' in the proposals. If not, revenue would not be recognised until sales are made to a third party. This would be a significant change from current practice.

Production-sharing agreements

Entities often enter into production-sharing agreements (PSAs) with governments to

exploit oil and gas resources. It will be critical to determine whether the government meets the definition of a customer under the proposals. If it does not, entities would account for the arrangement as they would any other prospect. However, where the government is a customer, entities would recognise revenue for the construction of the asset. A receivable would be recognised instead of an oil and gas asset and would be settled with a share of oil produced in the future.

The ED proposals focus on fulfilment of performance obligations before recognising revenue. The IASB continues to deliberate the circumstances in which performance obligations are satisfied continuously; the final conclusions could affect the time at which revenue is recognised.

Volumetric production payments

Volumetric production payments (VPPs) are structured transactions where entities sell a specific volume of future production from a specified resource for up-front cash. The buyer assumes reserve, production and pricing risk, as the arrangement is legally considered to be the sale of an interest. Current accounting for this type of transaction is to recognise deferred revenue and amortise this as production occurs.

The proposals would require a VPP to be segmented into two elements – transfer of legal title to reserves and future lifting services – with the cash received allocated between these. The transfer of legal title could trigger the recognition of revenue immediately. However, there is another view: that the transaction is the disposal of an interest, and only the resulting net gain or loss should be recognised in the income statement.

Revenue for the lifting services would be deferred until the service was provided. The proposals to consider the time value of money when there is a ‘significant financing’ element to transactions may result in a grossing-up of revenue and interest expense to reflect the finance cost. Revenue recognised could therefore exceed cash received.

PwC practical guide

The IASB’s ongoing discussions may clarify some of the above uncertainties. The Oil & Gas supplement to our practical guide on the Revenue proposals will be available soon on pwc.com/ifrs. It examines these and other issues in more detail.

IFRS IC – review of recent activity



Koon Min Wong

The IFRS Interpretation Committee (IFRS IC) has considered a number of requests for interpretation in the last year. The majority were rejected as being outside the remit of the Committee, as they were the subject of an ongoing IASB project; eight are proposed for inclusion as potential Annual Improvements. Koon Min Wong of PwC’s Global ACS Central Team reviews the status of those requests still active.

Vesting/non-vesting conditions

The Committee is addressing the issues caused by unclear definitions of vesting and non-vesting conditions, service conditions and performance conditions. It decided in November to propose clarifications to the definitions of service conditions and performance conditions in the next Annual Improvements cycle. Two issues were referred to the IASB for future IFRS 2 proposals: the accounting for non-compete provisions, and accounting for multiple vesting conditions.

Stripping costs in production phase of surface mine

This issue was taken on by the Committee in November 2009. It relates to whether, and to what extent, stripping costs can be capitalised. A draft interpretation was published in August 2010. The Committee is still discussing the comments received. A revised draft interpretation is expected to be discussed at the May 2011 meeting.

Contingent pricing of fixed and intangible assets

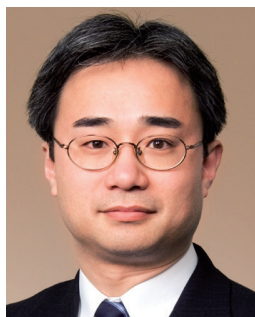
The Committee took on this issue, which relates to the treatment of the variation in

contingent elements of acquisition prices for fixed assets and intangible assets, in January 2011. Variations may be accounted for as an adjustment to asset costs, or variations could be taken to profit or loss as they occur. Technical arguments exist for both treatments; further discussion is expected at the May 2011 meeting.

Put options written over non-controlling interests (NCI)

This topic has been the subject of debate for many years. IAS 32, ‘Financial instruments: Presentation’, requires recognition of a liability for put options written over shares held by NCI measured at the present value of the strike price. IAS 39, ‘Financial instruments: Recognition and measurement’, requires variation in the liability over the life of the option to be taken to the income statement. There is concern that, in certain situations, this may result in income statement volatility that does not reflect commercial reality. For example, a written put to purchase shares held by NCI at fair value at the time of exercise does not expose the reporting group to any fair value risk, yet the income statement will include volatility arising from the changes in fair value over the life of the option. The Committee decided last month to recommend that the IASB exclude such written puts that meet certain conditions from the scope of IAS 32 as a short-term solution. This would result in those instruments being treated as derivatives at fair value through profit or loss and so being measured on a net basis rather than gross.

Transition issues from around the world – Japan



Hitoshi Kiuchi



Trevor Tisserverasinghe

This is the latest article in the series about issues affecting countries that are moving to IFRS. Hitoshi Kiuchi and Trevor Tisserverasinghe, partners in PwC's Accounting Consulting Services in Japan, look at the differences in local GAAP that have been created by the application of detailed guidance; subsidiaries with different reporting dates; and standardising group accounting.

Differences in GAAP created by the application of detailed guidance

There are a number of areas under Japanese GAAP where detailed guidance has been provided by the Accounting Standards Board of Japan (ASBJ), the Japanese Institute of Certified Public Accountants (JICPA) and tax rules. The strict application of some of this detailed guidance might result in a solution under Japanese GAAP that differs from the principles in IFRS, although there is no perceived GAAP difference between the two sets of standards. This is because the application of the guidance, especially where there are 'bright lines', removes the application of management's judgement. Some examples are provided below.

Deferred tax

JICPA guidance classifies entities into five categories, based on their profitability. It

defines, for each category, the time horizon of future taxable income to be considered in the assessment of the recoverability of the deferred tax assets.

Impairment of listed securities

The JICPA mandates recognising impairment when the fair value of listed securities falls below 50% of the purchase cost.

Depreciation

Property, plant and equipment are depreciated over their life by applying the straight-line or declining balance methods, as required by tax law. This is accepted by the JICPA unless the method is deemed to be unreasonable. However, the threshold for 'unreasonable' may be high in practice.

Scope of consolidation

Entities are consolidated if they are controlled by the parent holding the majority of the voting rights. Subsidiaries whose parent entities hold between 40% and 50% of the voting rights are consolidated based on the list of indicators of control provided by the ASBJ. Entities where the holding is less than 40% are generally not considered for consolidation. The implications of the detailed guidance that is followed in practice will need to be considered as entities transition to IFRS.

Local background

- Japanese GAAP is closely linked with the local tax rules. It is predominantly rules-based, with detailed guidance provided by the ASBJ and JICPA in a number of areas.
- The ASBJ accelerated its convergence efforts by signing the Tokyo agreement in August 2007, which sets target dates for short-term (December 2008), medium-term (June 2011) and long-term IFRS/Japanese GAAP convergence projects.
- Voluntary adoption of IFRS on a consolidated basis started for the year ended March 2010. A decision on mandatory adoption will be made in 2012, with an implementation date of either 2015 or 2016. One entity has voluntarily produced IFRS financial statements for the fiscal year ended March 2010; some entities have already produced IFRS financial statements for overseas listing purposes (most new US listings of Japanese entities apply IFRS); and others have started to prepare for the move to IFRS in Japan.
- A number of public bodies in Japan have started discussion forums, created educational tools, etc, as well as engaging with the IASB on their deliberation of new IFRSs.
- Moving from a rule-based environment to a more principles-based framework continues to raise concerns, including potential diversity in interpretation. Another complication is the nuances that may be lost in the translation of the standards.
- Discussions regarding the impact on regulatory and tax treatments with the change to IFRS also continue.

Subsidiaries with different reporting dates

Japanese companies generally have fiscal years ending in March, whereas in many other countries around the world the fiscal year ends tend to be in December. In many cases, the reasoning is historical and driven by local regulatory or tax requirements. Therefore, for many Japanese companies with significant overseas operations, this has meant consolidating subsidiaries with different reporting dates.

Japanese GAAP allows an entity to use the subsidiary's accounts as of a different reporting date for consolidation, provided the difference between reporting dates is not more than three months. IAS 27, 'Consolidated and separate financial statements', provides a similar allowance

when it is impracticable for a subsidiary with a different reporting date from its parent to prepare financial statements as at the same reporting date as its parent. However, when such an allowance is used, adjustments need to be made for significant transactions or events that occur between the reporting date of the subsidiary and that of its parent.

On transition to IFRS, given the high hurdle for using the impracticability allowance and the need to adjust for significant transactions where this allowance is used under IFRS, Japanese companies will need to consider aligning the reporting dates of its subsidiaries with different reporting dates or introduce processes at these subsidiaries to produce additional financial statements as at the reporting date of its parent.

Standardising group accounting

IAS 27 requires consolidated financial statements to be prepared using uniform accounting policies for like transactions and other events in similar circumstances for all entities within a group. Japanese GAAP has similar requirements, but it provides an exemption for consolidated foreign subsidiaries applying accounting policies based on either IFRS or US GAAP. There might therefore be differences in accounting policy between IFRS, US GAAP and Japanese GAAP across consolidated group companies. On transition to IFRS, management will need to draft accounting manuals for the consolidated group that address the GAAP differences with IFRS and align the accounting policies across the group for like transactions and other events in similar circumstances.

For further help on IFRS technical issues contact:

Business Combinations and Adoption of IFRS

mary.dolson@uk.pwc.com: Tel: + 44 (0)20 7804 2930
caroline.woodward@uk.pwc.com: Tel: +44 (0)20 7804 7392

Financial Instruments and Financial Services

john.althoff@uk.pwc.com: Tel: + 44 (0)20 7213 1175
jessica.taurae@uk.pwc.com: Tel: + 44 (0)20 7212 5700
elizabeth.m.lynn@uk.pwc.com: Tel: + 44 (0)20 7804 0306

Liabilities, Revenue Recognition and Other Areas

tony.m.debell@uk.pwc.com: Tel: +44 (0)20 7213 5336
mark.lohmann@uk.pwc.com: Tel: +44 (0)20 7212 4482

IFRS news editor

joanna.c.malvern@uk.pwc.com: Tel: +44 (0)20 7804 9377

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. It does not take into account any objectives, financial situation or needs of any recipient; any recipient should not act upon the information contained in this publication without obtaining independent professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2011 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.