IFRS news

In this issue:

1 **IASB leasing Project**
The comments letters are in

3 **IASB revenue project**
Are we there yet?

5 **Cannon Street Press**
IAS 1 narrow scope amendments

Joint arrangements narrow scope amendments

Impairment of financial assets

Rate regulated activities

IASB's work plan

7 **Questions and answers**
'K' is for Know your common control

9 **The bit at the back...**

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Leasing – the comments are in

The comment letters on the IASB and FASB's joint exposure draft (ED) on leases raise many concerns about the boards' proposals. Fernando Chiqueto from PwC's Accounting Consulting Services examines what respondents said and outlines the next steps.

The comment period for the proposed leasing standard has come to an end. But it looks like the debate has just begun.

Over 600 letters were received by the IASB and FASB in response to the ED. The responses, discussed in more detail below, reveal mixed support. Many reactions have been less than positive and some go as far as implying financial meltdown if the proposals were to go ahead. More recently the Investor Advisory Committee (IAC)[1] expressed that lease proposal is not an improvement to current lease accounting and supported a comprehensive disclosure package that would allow investors to better understand the risks and uncertainties related to lease contracts.

It has already been a long journey and after two years of re-deliberations, a clear ending is still not in sight. Does anyone remember how we got here?

How did we get here?

The IASB reminded us recently why this project was initiated.[2] Investors and analysts go to the trouble of adjusting a lessee's balance sheet to capitalise operating leases and recognise an obligation for future payments. Such adjustments can unfortunately result in inaccurate estimations and lack of comparability among entities.

The need to adjust is a consequence of the current accounting model which only requires a lease to be reported on the balance sheet when it is economically similar to purchasing an asset. So the majority of the leases (operating leases) are reported off-balance sheet.[3] The new proposal aims to address this issue and improve the quality of information in other areas, such as lessor accounting.

The following summary of the responses received details some of the concerns and at the same time highlights the key effects of the proposal if it goes ahead.

[1] The IAC works closely with the FASB in an advisory capacity to ensure that investor perspectives are effectively communicated to the FASB on a timely basis in connection with the development of financial accounting and reporting standards.

[2] 'Investor Spotlight: Potential changes in lease accounting'. Available in http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/Investor-spotlight-leases.pdf

[3] According to the SEC, in 2005 U.S. public companies had approximately $1.25 trillion of off-balance-sheet operating leases. See http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Documents/Snapshot-Leases-May-2013.pdf

The comments received

Identifying a lease

Control over an identified asset is the key determinant of whether an arrangement is a lease. In simple terms, this is when the customer has the ability to direct the use and derive benefit from the use of an identifiable asset.

Most respondents support this principle. However, concerns over practical application were expressed specifically on: i) distinguishing service contracts from lease arrangements, ii) evaluating substitution rights and iii) assessing decision making rights for control assessment purposes.

Interaction with IFRS 10
Some respondents have requested more clarity on how the current consolidation rules in IFRS 10 are aligned with the examples in the ED.

Lessee model

The proposed model requires a lessee to recognise a right-of-use asset and a lease liability for all leases greater than 12 months. The expense recognition pattern depends on the nature of the underlying asset. Expense is recognised on a straight-line basis for most property leases (Type B), while non-property leases (Type A) result in front-loaded expense.

Most respondents support the principle that an entity should recognise assets and liabilities arising from a lease. However, only a few support the dual approach for expense recognition. Most felt that a concept based solely on the nature of the leased asset introduces a bias for one approach or the other. They said that the economics are not always based on the asset type. In addition, leases often include both asset types as components, which leads to complexity.

A number of alternatives have been suggested. Some advocate going back to the original ED with only one type of lease. Others go as far as to suggest retaining IAS 17 with additional disclosures.

Type A or B?
Many commented that a new dividing line based on the nature of the underlying asset reduces usefulness and does not represent an improvement over the current accounting model.

Lessor model

The ED proposes few changes to lessor accounting for finance leases. For operating leases, a lessor distinguishes between leases of property and non-property in the same way as a lessee.

Fewer comments were made about the lessor model. For those who did comment, there was little appetite for change. Most do not believe symmetry between lessee and lessor income statement models is necessary. Some called for consistency with the proposed revenue standard which covers accounting for licences.

Lease term

The lease term is the non-cancellable term plus any options to extend when a significant economic incentive to exercise such options exists. Respondents requested more clarity on what 'significant economic incentive' means and how it is different from the existing guidance of 'reasonably certain' in IAS 17 today.

Variable payments - reassessment

Lease payments include both variable amounts based on a rate or an index and those that are in substance fixed. The proposals require that the lease liability is remeasured for changes in the rate or index.

Many respondents found the requirement to reassess complex and burdensome. Some suggested applying a materiality threshold since changes in value driven by variables like CPI are too small to warrant the effort.

Transition and disclosures

Many respondents noted that the proposed disclosure requirements are extensive and complex. Many also noted that it will be costly and time consuming to implement.

Most support the proposed modified retrospective application. Suggestions to ease the transition included applying a prospective method and excluding leases that have expired by the effective date.

Do the costs outweigh the benefits?
Comments expressed concerns regarding complexity and costs to implement the new proposals.

Where to go from here?

The IASB will begin redeliberations in the next few months, but the future is not clear. Although many expressed dissatisfaction with the current proposals, no action at all seems unlikely given the origins of the project.

There also remains a question of convergence with US GAAP. There were some rather negative responses from US constituents. So it will be interesting to see if the FASB still remains committed to convergence.

Revenue – are we there yet?

The IASB and FASB met in October to finalise the last three outstanding issues on their joint revenue recognition project. We look at the key decisions and next steps below.

The IASB and FASB met in October for what is likely to be the final joint board meeting on the revenue project. There were three issues discussed – variable consideration, licences and collectability. All of which have attracted significant controversy over the life of the project and particularly during the last few months.

The project has been seen as a success in joint standard setting but the final deliberations were marked by what many would call compromise for convergence. However, with the standard expected to be effective in 2017, many will be relieved to have these fundamental issues resolved, even though it has been eight months since the deliberations were described as substantially complete.

Let's have a look at where the boards got to this month.

The final decisions

Constraint on variable consideration

The boards concluded that variable consideration is included in the transaction price if it is 'highly probable' under IFRS ('probable' under US GAAP) that the amount would not result in a significant revenue reversal. Management must reassess this each reporting period.

The boards reversed an earlier decision by reintroducing an exception for revenue from sales- or usage-based royalties from licences of intellectual property (IP). The revenue from such royalties cannot be recognised until it is no longer variable (that is, when customer's subsequent sales or usages occur). The exception only applies to licences of IP, not other royalty arrangements.

Many will see this decision as a simplification of the models previously discussed. This is because the 'probability' threshold is generally easier to understand, implement and explain. The requirement to reassess might, however, create complexity although many of the tricky arrangements will be caught by the exception for royalties.

Licences

The proposals distinguish between two types of licences – one that provides a *right to use* IP, and one that provides *access to* IP. The type depends on whether the nature of the underlying IP is 'dynamic' or 'static'. A licence of static IP is considered a right to use. Revenue is recognised when control has been transferred, normally at a point in time when the customer has control and is able to use the IP. A licence of 'dynamic' IP provides access with revenue recognised over time.

Licences are dynamic when the licensor undertakes activities that significantly affect the IP in a way that also affects the customer. The guidance significantly extends today's literature. Application of this guidance will however require judgment and implications for existing practice are likely to vary.

Collectability

The boards introduced a collectability threshold. Revenue is not recognised unless collection is 'probable'. Such a threshold was debated several times and dismissed primarily due to concerns over consistency with the rest of the model. The threshold proposed this time around is to be included in the criteria used to determine when a contract exists. This helps to ease concerns that a recognition threshold based on collectability is not consistent with the control model.

But 'probable' means something different under IFRS and US GAAP. Under IFRS, it means more likely than not. The US GAAP meaning of probable is the equivalent of IFRS's 'highly probable'. Although convergence has not been achieved, the thresholds selected by the two boards are consistent with their respective guidance today under IFRS and US GAAP. The effect of non-convergence in practice is to be determined.

What is next?

The staff will probably be busy putting pen to paper for a few months. A final standard is expected in early 2014. An effective date of 2017 is still the plan but this might be reconsidered if the standard is not published in the near term.

There has been no news on the next steps for the implementation group announced in July. The objective for the group is to help the boards determine if action is required to resolve diversity in practice. It is planned to operate for a limited period with the primary activity occurring before the transition date in 2017.

New IFRS publications released

We've published the following accounting guidance for 2013 year ends:

- Illustrative IFRS consolidated financial statements
- IFRS pocket guide 2013
- Similarities and differences:
  - Comparison of current UK GAAP, new UK GAAP (FRS 102) and IFRS
  - Comparison of IFRS and US GAAP (email kerstine.stephenson@us.pwc.com for hard copies)

For hard copies, visit www.ifrspublicationsonline.com.

For electronic versions, visit inform.pwc.com (free trial available).

Cannon Street Press

Narrow scope amendments to IAS 1

The IASB continued discussions of the narrow focus amendments to IAS 1.

Net debt reconciliation

The board will move forward with a project to consider a requirement in IFRS to disclose a 'net debt' reconciliation. They decided however that this matter goes beyond the scope of the current project to clarify IAS 1 through narrow scope amendments. The next steps and planned scope will be discussed at a future meeting.

Totals and subtotals

There were mixed views about how and whether IAS 1 should clarify factors that an entity should consider when disclosing totals and subtotals. The IASB, however, is moving forward with an exposure draft. They decided not to include specific examples of commonly reported totals or subtotals such as EBIT or EBITDA in IAS 1.

Current and non-current classification

The board confirmed that classification of a liability depends on the contractual agreements in existence at the reporting date and suggested a number of clarifications to IAS 1.

The board discussed rollovers/ refinancings. They determined that a new loan exists if there is a significant change in terms. This means that a liability originally due to be settled within twelve months can be classified as non-current when an entity rolls it over or refinances with the same lender *with the same or similar terms* before the reporting date.

The board also discussed the breach of covenants after the reporting date but did not conclude on this matter.

Impairment of financial assets

The IASB continued deliberations on IFRS 9. This month, activity focused on the impairment project. They made the several tentative decisions as they address feedback from the comments letters and other outreach. The key decisions include:

- Clarification that the 12 month expected credit losses (ECL) are a portion of the lifetime ECL and are not the cash shortfalls that are predicted over the next 12 months.
- Confirmation that the rebuttable presumption that a financial asset has increased its credit risk when payments are more than 30 days past due.
- Confirmation that entities may assume, as a practical expedient, that there has not been a significant deterioration in low credit risk instruments.
- The effective interest rate (EIR) is the appropriate discount rate. If the EIR is not known, an approximation should be calculated on a reasonable basis. If an approximation cannot be made, a risk-free rate is used.

Deliberations will continue next month. A standard is expected in the first half of 2014.

Narrow scope amendments on joint arrangements

The Board discussed comment letter feedback on the following 3 narrow-scope amendments related to joint arrangements and equity method accounting:

- Equity Method: Share of Other Net Asset Changes (ED/2012/3)
- Sale or Contribution of Assets between an Investor and its Associate or Joint Venture(ED/2012/6)
- Acquisition of an Interest in a Joint Operation(ED/2012/7)

Many were concerned that inconsistencies would arise unless the proposed amendments were deliberated together. The Board decided to finalise the proposals in ED/2012/6 and ED/2012/7 with the several updates. The Board will continue deliberations on ED/2012/3 at a future date.

For the sale or contribution of assets between an investor and its associate or joint venture (ED/2012/6), the boards clarified that the level of gain/loss recognition will depend on the nature of the assets. The full gain/loss is recognised for assets that constitute a business under IFRS 3 and partial gain/loss is recognised for assets that do not constitute a business under IFRS 3 (gain/loss is limited to the interest of the other investors).

For the acquisition of an initial or additional interest in a joint operation (ED/2012/7), the Board confirmed that relevant principles of IFRS 3 will be applied when the joint operation constitutes a business as defined by IFRS 3.

Rate regulated activities

Interim standard

The IASB plans to go ahead with an interim standard on rate regulated activities. This decision was made in light of mixed views from respondents on the exposure draft.

The proposals are only applicable to entities that apply IFRS 1 as a first-time adopter of IFRS and meet certain criteria. They allow such entities to continue to apply their previous GAAP accounting policies for the recognition, measurement and impairment of regulatory deferral accounts when IFRS is adopted.

The IASB began redeliberations looking at clarification to the scope, presentation and disclosure requirements and interactions with other IFRSs. A final standard is expected before year-end or early 2014.

Research project

The board continued their discussions on the research project to determine if rate regulation creates assets or liabilities and whether (or how) IFRS should be amended. They discussed two key aspects of the project: features of rate regulation and unit of account. A discussion paper is expected in early 2014.

IASB work plan as of 5 November 2013

The following summary reflects the next major milestone for the key projects. The boards continue to discuss the Conceptual Framework and a number of narrow scope amendments and research projects.

Project	Milestone	Expected date per Work plan
Major IFRSs		
IFRS 9 – Classification and measurement (limited amendments)	Final standard	H1 2014
IFRS 9 – Impairment	Final standard	H1 2014
IFRS 9 – Hedge accounting	IFRS	Q4 2013
Accounting for macro hedging	Discussion paper	Q4 2013
Revenue recognition	IFRS	Q1 2014
Leases	Redeliberations	Q4 2013
Insurance	Redeliberations	Q4 2013
Rate regulation	Discussion paper	Q1 2014
Rate regulated activities – interim IFRS	Redeliberations	Q1 2014

Know your IFRS 'ABC': K is for 'Know' your common control

Elena Belokovylenko from PwC's Accounting Consulting Services Central Team touches on the key considerations when accounting for transactions under common control.

A scope exemption in an accounting standard is like a black hole in space; you need to pay attention to what isn't there. The 'common control' scope exemption in IFRS 3 seems to exert a disproportionate gravitational pull. It is both misunderstood and misapplied. This short article explains when it is appropriate to use the common control exemption and established practice around the 'how' to do it.

IFRS 3 does not apply to 'a combination of entities or businesses under common control'. This is further defined as 'a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.'

There are two conditions that must be met for the scope exemption to apply; a) common control and b) a business combination. Both are explored below.

Does common control exist?

The application guidance provides a definition and touches on several key points:

- A group of individuals is regarded as controlling an entity when there are contractual arrangements in place to create collective control over the financial and operating policies of the relevant entity or entities.
- It is not necessary for entities under common control to be included in the same consolidated financial statements. For example, the group of individuals above might not prepare IFRS financial statements. Likewise, there are many business enterprises in China that are controlled by different branches of the government. These are deemed to be under common control by virtue of that ownership.
- The extent of any non-controlling interest is not relevant to the determination of common control; so a subsidiary with a non-controlling interest that is combined with a wholly owned subsidiary would be a common control business combination.

Is it a business combination?

No other IFRS standards have scope exemptions for common control. IAS 24, 'Related Party Disclosures' does not have any measurement rules for related party (such as common control) transactions. Therefore, the normal measurement guidance in other standards applies to common control transactions in the scope of those standards. For example, the sale of a piece of machinery from one controlled subsidiary to another is in the scope of IAS 16 or potentially IFRS 2.

Only business combinations under common control benefit from a scope exemption. There is a temptation to apply the scope exemption to other transactions, for example, transfers of groups of assets that are not a business, transfers of financial instruments and transfers of interests in associates and joint ventures. The accounting for a group of assets is an allocation of consideration under IFRS 3 and the initial recognition of a financial instrument is at fair value. Scope is a rule, specific to a particular standard. It is not appropriate to apply scope exemptions by analogy.

Scope exemption applies- what do I do now?

Scoped out of IFRS 3 and not scoped in to any other standard means that you need to use IAS 8 to develop an accounting policy that is relevant to the decision-making needs of users and is also reliable. Two common approaches have developed in practice: the acquisition method prescribed by IFRS 3 and predecessor accounting.

There is an attractive simplicity to the predecessor method that means it is the option most frequently chosen; assets or liabilities are not restated to their fair values. Instead, the acquirer incorporates predecessor carrying values, including any goodwill previously recognised by the predecessor in respect of the acquired entity. Many will also present comparative information for the newly combined entity as if the acquired entity has always been part of the group, although this is not permitted in some territories.

Some entities have chosen to apply IFRS 3 by analogy, despite the complexity. When applying IFRS 3 by analogy, all aspects of the standard need to be applied. This includes those aspects that are particularly complex or counter-intuitive such as deferred tax, contingent consideration and revaluation of previously held interest. However, sometimes IFRS 3 is not available because a fundamental aspect of the definition is not met; in other words, the scope exemption is not available. The common control business combination needs to be a 'business combination'. A new company ('newco') that is formed to issue shares in a business combination cannot be an acquirer. Many transactions described as 'common control business combinations' are actually capital reorganisations and should be accounted for accordingly.

How do I account for a capital reorganisation?

The combination of a newco and an operating company will not meet the definition as a business combination and so neither IFRS 3 nor predecessor basis is available. It is a capital reorganisation and the newco's consolidated results will include the existing operating company full results, including comparatives, irrespective of when the transaction occurred.

A newco is frequently used when businesses are reorganised, restructured or otherwise prepared for sale. IFRS 3 is rarely available for these transactions and thus no 'new basis' or fair value uplifts are included in the consolidated financial statements of the newco. Additional complexity arises when a newco is used to bring together entities under common control from different parts of a group into a new sub-group. It's time to seek input from specialists and understand what the relevant regulator is looking for in terms of presentation and measurement.

The bit at the back.....

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