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Dbriefs

Q&A Report

IFRS: Important Third Quarter Developments

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1. Would the change to financial statements presentation – merging income statement and SOCI – mean that movements on the surplus / deficit on a DB pension scheme (for example) would go through income statement rather than reserves?

The proposal to have a single, continuous statement of comprehensive income would not affect how items are currently classified (Other Comprehensive Income versus Profit or Loss) or if items are recycled out of Other Comprehensive Income into Profit or Loss.

2. Generally, how would you envisage the new standard on revenue recognition impact the utilities industry? What would be the major impacts?

It is probably unsafe to generalize about the impact for the utilities industry as a whole. The contractual arrangements for different utility companies will differ; also, in the absence of detailed requirements in IAS 18 for certain subjects (e.g. unbundling), there may currently be some diversity in practice.

Nevertheless, potential issues that such companies might wish to consider could include the following:

- Utility companies will often have a very large volume of relatively small contracts, many of which will run for many years. There may be challenges in collating the information required in relation to the disclosures proposed by the exposure draft
- The proposed requirement to consider collectibility as part of the initial measurement of revenue may result in revenue being measured at a lower amount

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- A utility company may supply more than one utility under a contract (e.g. bundled gas and electricity supplies). The new requirement to allocate revenues pro rata to standalone selling price may be different from the allocation currently used by some utility companies
- Particularly where prices have been fixed in advance, the requirement to consider whether individual performance obligations (rather than contracts as a whole) have become onerous may result in increased recognition of provisions. (This may be particularly relevant for contracts that bundle together more than one utility)
- Where long-term supply arrangements have been specifically negotiated with individual large customers, any subsequent modifications to those agreements may be accounted for differently under the exposure draft's proposals

This should not be seen as a complete list. Depending on the contractual arrangements that utility companies have, there could be other impacts as well.

3. Is there any extra guidance required for the treatment of sub-contract cost as given in paragraph 25 of IAS 11?

Paragraphs 57 to 63, B89 and B90 of the exposure draft set out detailed proposals on which costs may be capitalized as contract costs and which must be expensed.

In the context of sub-contract arrangements, it will be important under the exposure draft to focus on:

- Whether the reporting entity is an agent or a principal (see paragraphs B20 to B23)
- Particularly if the reporting entity is a principal, when the customer obtains control of the associated goods and/or services (see paragraphs 25 to 33 and B44 to B73)

Paragraph 25 of IAS 11 describes the percentage of completion method. To the extent that similar accounting would be appropriate under the exposure draft, the exposure draft describes this as the "continuous transfer of goods or services". Paragraph 33 of the exposure draft describes various methods that might be adopted to depict such continuous transfer, and these may be contrasted with the methods described in paragraph 30 of IAS 11.

4. Is this upfront loss recognized on a provisional basis and then reversed in the end of the year? I ask this with respect to loss on separately priced extended warranty contracts.

Under the exposure draft, revenue in respect of extended warranty contracts will be deferred and recognized on an appropriate basis over the warranty period. The amount deferred will not necessarily be the amount specified in the contract; for a

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contract containing multiple performance obligations, it will be necessary to follow the methodology specified in the exposure draft to allocate the total transaction price between performance obligations, including warranty.

The main difference between the exposure draft and the existing requirements for onerous contract provisions is that the latter focus on whether a contract as a whole is onerous, whereas the exposure draft focuses on whether an individual performance obligation is onerous. Thus, under the exposure draft, a provision may be recognized even for a contract that is profitable overall.

Under the exposure draft, if a performance obligation is judged to be onerous, a provision will be recognized to the extent that costs associated with the obligation exceed the amount of the transaction price allocated to the obligation. At the end of each reporting period, updated estimates are prepared for both the costs and the allocated transaction price, and the provision is re-measured accordingly. However, a provision for an onerous performance obligation will only be derecognized when either the obligation has been satisfied (such that any loss has crystallized) or the allocated transaction price is now estimated to exceed the associated costs.

5. If I am in construction industry and I am performing job at the customer site. Is it means that control is transferred to customer immediately after the work performed but not for unused material?

It is not possible to give a general answer to this question. The approach taken by the exposure draft is different from that in IAS 11, so it will always be necessary to apply the exposure draft to the specific facts and circumstances.

In some cases where construction activity is occurring at a customer site, it is likely that there will be a continuous transfer of goods or services, such that the customer has control of the partly-constructed asset. For example, if:

- The customer has an unavoidable obligation to pay for construction work to date;
- The customer has legal title to the partly-constructed asset;
- The customer has physical possession of the partly-constructed asset; and
- The design or function of the asset being constructed is customer-specific;

then all of the indicators of customer control in paragraph 30 of the exposure draft would be met. In other cases, where not all the indicators are met, a greater degree of judgment may be required.

Example 11, below paragraph B43 of the exposure draft, describes a scenario in which there is a continuous transfer of goods or services. In that example, the customer obtains control of materials and equipment only as they are installed, i.e. the seller still has control of materials and equipment that have not yet been installed.

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6. **What is the logic of not revising the discount rate when the lease term is revised and consequently the liability amount is increased or decreased?**

   The Boards believe the option to extend is an integral part of the lease at the date of inception of the lease, and the pricing of the lease reflects the option. Therefore, the Boards propose that the discount rate used to determine the present value of lease payments should not be revised when there are subsequent reassessments of the expected lease term or contingent rentals, unless the lease payments are contingent on variable reference interest rates. The Boards also noted that this conclusion reflects conditions at the date of inception of the lease, which is consistent with the notion of cost-based measurement. Also, this approach is less complex and costly for preparers to apply. The IASB also noted that this approach is consistent with the measurement principles of amortized cost in IAS 39 and [draft] IFRS *Financial Instruments: Amortised Cost and Impairment*.

7. **Would the change in accounting policy for leases trigger the need for the third balance sheet and therefore two years of comparatives would need to be presented?**

   It appears so based on how the proposed transition requirements are worded in the exposure draft. The proposed transition requirements are based on a simplified retrospective method and, therefore, would appear to be covered by paragraph 39 of IAS 1. The transition requirements could change in the final standard.

8. **Is any guidance proposed to clarify when a lessor has: a) sold an asset (transfer of control and all but a trivial amount of risks / benefits) versus b) lease asset using derecognition approach (no transfer of control but transfer of significant risks / benefits)? The practical distinction is likely to be very grey resulting in much diversity in practice / judgment? What is DTT's view?**

   The following guidance is from paragraphs B22-B27 of the Exposure Draft:

   A lessor shall consider the following factors in assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during the expected term of the current lease:

   a) Significant contingent rentals during the lease term that are based on the use or performance of the underlying asset
   b) Options to extend or terminate the lease
   c) Material non-distinct services provided under the current lease

   The existence of material non-distinct services may expose the lessor to a significant risk that the lessee will terminate the lease early because of the non-provision of those services. When the risk that the lessee will terminate the

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lease early is significant, the lessor is likely to be exposed to significant risks or benefits associated with the underlying asset during the term of the lease.

A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:

a) Whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset
b) Whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:
    i) The present value of the underlying asset at the end of the lease term
    ii) The effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits

In general, a residual value guarantee will reduce a lessor's exposure to downside risk but may give the lessor the potential to benefit from increases in the expected value of the underlying asset at the end of the lease.

The existence of one or more indicators is not conclusive in determining whether the lessor retains exposure to significant risks or benefits associated with the underlying asset.

DTT has not yet formulated its views on the proposals.

9. You mentioned that when allocating the transaction price, if the separate performance obligations came to more than the value of the sales contract you'd pro rata the surplus revenue across the elements. What about in the converse situation where the transactions prices of the individual elements came in less than the price of the contract? Would you allocate the shortfall across the performance obligations pro rata as well?

The methodology proposed in paragraph 50 of the exposure draft does not distinguish between scenarios in which the total transaction price is higher or lower than the aggregate standalone selling prices. Therefore, it appears that, in both cases, revenue would be allocated on a pro rata basis.

However, in practice, it might be unusual for a total contract price to exceed the aggregate of standalone selling prices, because this would imply that the customer could obtain the overall package more cheaply by buying the individual elements separately. Therefore, in such circumstances, it might be appropriate to re-check any standalone selling prices that have had to be estimated, as an overall surplus may indicate that, in some cases, the estimated standalone selling price for an element is too low.

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10. **In case of construction contracts – as per IAS 32/39 advances from customers is not a financial asset and there is no need to discount the same but under ED time value of money needs to be factored. Please clarify.**

    Generally, if a customer pays in advance and has no automatic right to demand repayment, the liability that arises for the seller will not be a financial liability within the scope of IAS 32 and IAS 39.

    Nevertheless, the exposure draft proposes that, where the effect is significant, the time value of money should be taken into account when a customer pays in advance. The liability will initially be recognized at the amount of cash received, but it will be remeasured subsequently to "unwind the discount" that was given to the customer for payment in advance. Thus, over time, the seller will recognize an expense for the unwinding of the discount; and when revenue is recognized, it will be measured at the amount of cash paid by the customer plus the discount that has been unwound on the liability.

    In effect, the exposure draft is proposing that the time value of money should be taken into account for such liabilities even though they are outside the scope of IAS 32 and IAS 39.

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