

This Update to *Intermediate Accounting* contains discussions of key accounting standards and other issues that have arisen since the publication of *Intermediate Accounting, IFRS Edition*, by Kieso, Weygandt, and Warfield. The Update consists of the following two elements: (1) **Completed Projects** provide the latest information about new accounting standards promulgated since the textbook was published, and (2) **Proposed Projects** address contemporary issues being debated by accounting professionals and standard-setters, which may result in new accounting standards.

Contents

Completed Projects

Conceptual Framework (UP-2). Discusses materiality as a qualitative characteristic of useful accounting information (Chapter 2, Conceptual Framework for Financial Reporting).

Comprehensive Income (UP-3). Relates to Chapter 4, Income Statement.

Fair Value Measurement (UP-5). Discusses updated fair value measurement and disclosure guidance (relates to discussions in Chapters 2, Conceptual Framework for Financial Reporting; 5, Statement of Financial Position; 7, Cash and Receivables; and 17, Investments).

Offsetting (UP-10). Proposed new guidance on offsetting (or netting) of financial assets and liabilities (Chapters 7, Cash and Receivables; 13, Current Liabilities; and 17, Investments).

Amendments to IAS 19 (Employee Benefits) (UP-13). Provides an overview of the amendments to *IAS 19, Employee Benefits*. A replacement chapter for Chapter 20 (Accounting for Pensions and Other Postretirement Benefits) is available at the book's companion website, www.wiley.com/college/kieso.

Proposed Projects

Financial Instruments (UP-15). Summarizes the IASB's project on financial instruments, which is a joint project with the FASB (Chapters 7, Cash and Receivables; 14, Long-Term Liabilities; and 17, Investments).

Revenue Recognition (UP-20). Discusses the IASB's joint project with the FASB on revenue (Chapter 18, Revenue).

Leases (UP-36). Summarizes the IASB's joint project with the FASB on leases (Chapter 21, Accounting for Leases).

COMPLETED PROJECTS

CONCEPTUAL FRAMEWORK

The discussion in this section provides background on revisions in the treatment of materiality as it relates to qualitative characteristics of useful accounting information in the conceptual framework. Replacement pages for affected material in Chapter 2 follow the Background section and are also available at the book's companion website, www.wiley.com/college/kieso.

Background

In September 2010, the IASB and FASB issued revised chapters in their conceptual frameworks, resulting in converged concepts statements related to the Objective of Financial Reporting (Chapter 1) and Qualitative Characteristics of Useful Financial Information (Chapter 3). However, the discussion of these topics in Chapter 2 of *Intermediate Accounting, IFRS Edition*, was based on the proposed (not final) chapters at the time the textbook was published in spring 2010. One element that changed in the final versions of these chapters, compared to the proposed concepts statements, concerned materiality.

In the proposed framework and consistent with the prior concepts statements, materiality was treated as a constraint in the conceptual framework. However, based on input from constituents, in the final revised chapter, materiality is presented as an element of the relevance—one of the primary qualitative characteristics—along with faithful representation.

Revised pages that reflect the updated treatment of materiality follow. These pages can be substituted for the discussion of qualitative characteristics on pages 43-47 in Chapter 2. The discussion of the materiality constraint on pages 57-59 may be dropped. Finally, a revised Illustration 2-7, which summarizes the “Framework for Financial Reporting,” is provided to replace page 60.

The following discussion reflects the most recent accounting standards concerning the conceptual framework. It should replace pages 43–47 and page 60, and the Materiality Constraint section on pages 57–59 may be dropped, in Chapter 2 of Intermediate Accounting, IFRS Edition.

SECOND LEVEL: FUNDAMENTAL CONCEPTS

The objective (first level) focuses on the purpose of financial reporting. Later, we will discuss the ways in which this purpose is implemented (third level). What, then, is the purpose of the second level? The second level provides conceptual building blocks that explain the qualitative characteristics of accounting information and define the elements of financial statements.¹ That is, the second level forms a bridge between the **why** of accounting (the objective) and the **how** of accounting (recognition, measurement, and financial statement presentation).

Qualitative Characteristics of Accounting Information

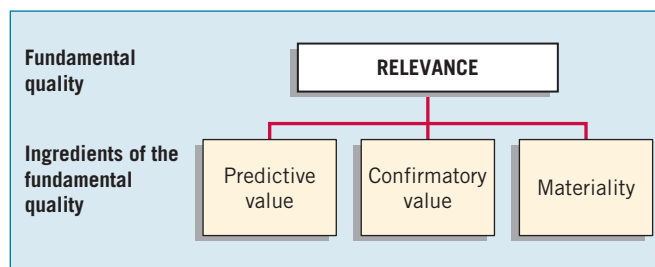
Should companies like **Marks and Spencer plc** (GBR) or **Samsung Electronics Ltd.** (KOR) provide information in their financial statements on how much it costs them to acquire their assets (historical cost basis) or how much the assets are currently worth (fair value basis)? Should **PepsiCo** (USA) combine and show as one company the four main segments of its business, or should it report PepsiCo Beverages, Frito Lay, Quaker Foods, and PepsiCo International as four separate segments?

How does a company choose an acceptable accounting method, the amount and types of information to disclose, and the format in which to present it? The answer: By determining **which alternative provides the most useful information for decision-making purposes (decision-usefulness)**. The IASB identified the **qualitative characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes. In addition, the IASB identified a cost constraint as part of the conceptual framework (discussed later in the chapter). As Illustration 2-2 (on page 2U-2) shows, the characteristics may be viewed as a hierarchy.

As indicated by Illustration 2-2, qualitative characteristics are either fundamental or enhancing characteristics, depending on how they affect the decision-usefulness of information. Regardless of classification, each qualitative characteristic contributes to the decision-usefulness of financial reporting information. However, providing useful financial information is limited by a pervasive constraint on financial reporting—cost should not exceed the benefits of a reporting practice.

Fundamental Quality—Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making. Relevance and related ingredients of this fundamental quality are shown below.

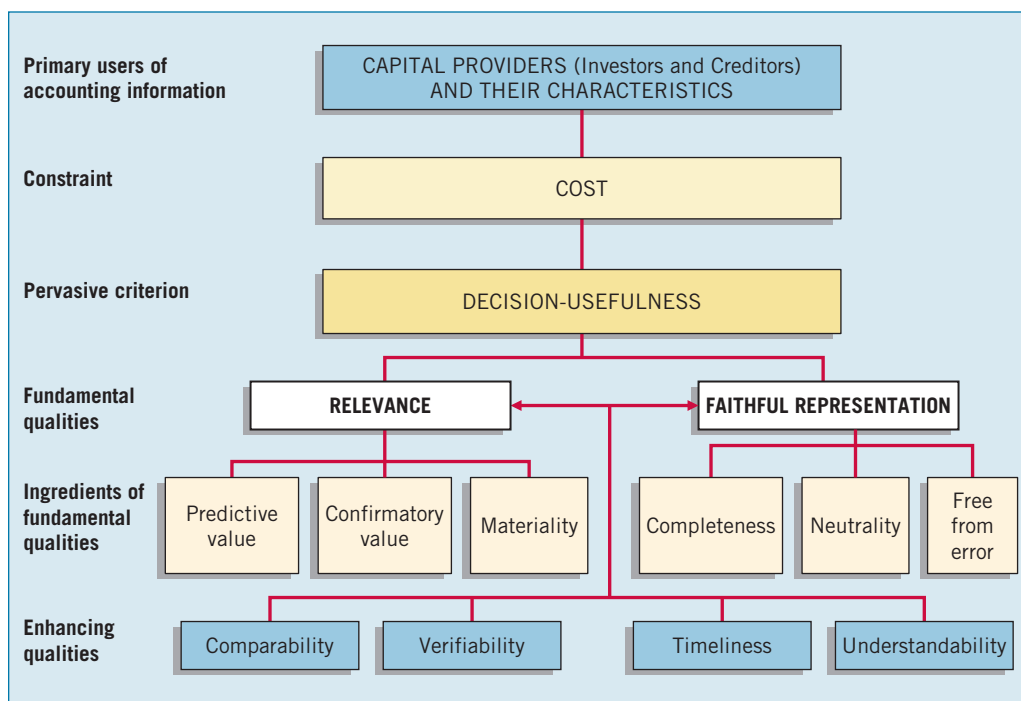


Objective 4

Identify the qualitative characteristics of accounting information.

¹The *Conceptual Framework for Financial Reporting*, “Chapter 3, Qualitative Characteristics of Useful Financial Information” (London, U.K.: IASB, September 2010).

ILLUSTRATION 2-2
Hierarchy of Accounting
Qualities



To be **relevant**, accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both.

Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future. For example, if potential investors are interested in purchasing ordinary shares in **Nippon (JPN)**, they may analyze its current resources and claims to those resources, its dividend payments, and its past income performance to predict the amount, timing, and uncertainty of Nippon's future cash flows.

Relevant information also helps users confirm or correct prior expectations; it has **confirmatory value**. For example, when Nippon issues its year-end financial statements, it confirms or changes past (or present) expectations based on previous evaluations. It follows that predictive value and confirmatory value are interrelated. For example, information about the current level and structure of Nippon's assets and liabilities helps users predict its ability to take advantage of opportunities and to react to adverse situations. The same information helps to confirm or correct users' past predictions about that ability.

Materiality is a company-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report. Information is *immaterial*, and therefore irrelevant, if it would have no impact on a decision-maker. In short, **it must make a difference** or a company need not disclose it.

Assessing materiality is one of the more challenging aspects of accounting because it requires evaluating both the **relative size and importance** of an item. However, it is difficult to provide firm guidelines in judging when a given item is or is not material. Materiality varies both with relative amount and with relative importance. For example, the two sets of numbers in Illustration 2-3 indicate relative size.

ILLUSTRATION 2-3
Materiality Comparison

	Company A	Company B
Sales	\$10,000,000	\$100,000
Costs and expenses	9,000,000	90,000
Income from operations	\$ 1,000,000	\$ 10,000
Unusual gain	\$ 20,000	\$ 5,000

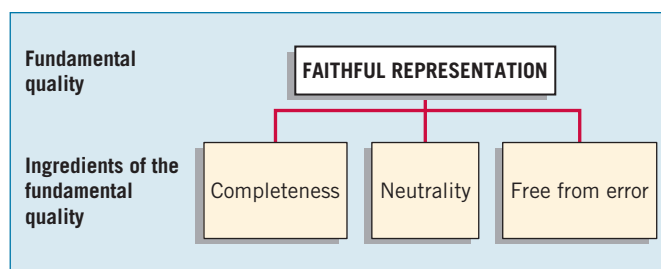
During the period in question, the revenues and expenses, and therefore the net incomes of Company A and Company B, are proportional. Each reported an unusual gain. In looking at the abbreviated income figures for Company A, it appears insignificant whether the amount of the unusual gain is set out separately or merged with the regular operating income. The gain is only 2 percent of the operating income. If merged, it would not seriously distort the income figure. Company B has had an unusual gain of only \$5,000. However, it is relatively much more significant than the larger gain realized by Company A. For Company B, an item of \$5,000 amounts to 50 percent of its income from operations. Obviously, the inclusion of such an item in operating income would affect the amount of that income materially. Thus, we see the importance of the **relative size** of an item in determining its materiality.

Companies and their auditors generally adopt the rule of thumb that anything under 5 percent of net income is considered immaterial. However, much can depend on specific rules. For example, one market regulator indicates that a company may use this percentage for an initial assessment of materiality, but it must also consider other factors.² For example, companies can no longer fail to record items in order to meet consensus analysts' earnings numbers, preserve a positive earnings trend, convert a loss to a profit or vice versa, increase management compensation, or hide an illegal transaction like a bribe. In other words, **companies must consider both quantitative and qualitative factors in determining whether an item is material.**

Thus, it is generally not feasible to specify uniform quantitative thresholds at which an item becomes material. Rather, materiality judgments should be made in the context of the nature and the amount of an item. Materiality factors into a great many internal accounting decisions, too. Examples of such judgments that companies must make include the amount of classification required in a subsidiary expense ledger, the degree of accuracy required in allocating expenses among the departments of a company, and the extent to which adjustments should be made for accrued and deferred items. Only by **the exercise of good judgment and professional expertise** can reasonable and appropriate answers be found, which is the materiality constraint sensibly applied.

Fundamental Quality—Faithful Representation

Faithful representation is the second fundamental quality that makes accounting information useful for decision-making. Faithful representation and related ingredients of this fundamental quality are shown below.



²"Materiality," *SEC Staff Accounting Bulletin No. 99* (Washington, D.C.: SEC, 1999). The auditing profession also adopted this same concept of materiality. See "Audit Risk and Materiality in Conducting an Audit," *Statement on Auditing Standards No. 47* (New York: AICPA, 1983), par. 6.

Faithful representation means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if **Siemens AG's** (DEU) income statement reports sales of €60,510 million when it had sales of €40,510 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

Completeness. **Completeness** means that all the information that is necessary for faithful representation is provided. An omission can cause information to be false or misleading and thus not be helpful to the users of financial reports. For example, when **Société Générale** (FRA) fails to provide information needed to assess the value of its subprime loan receivables (toxic assets), the information is not complete and therefore not a faithful representation of their values.

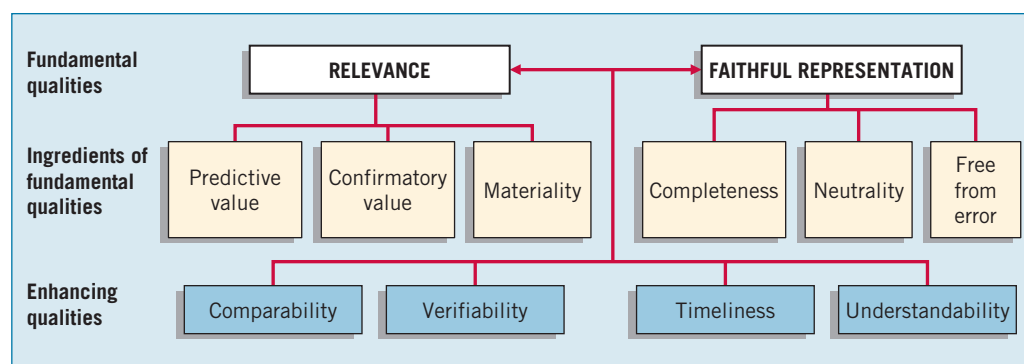
Neutrality. **Neutrality** means that a company cannot select information to favor one set of interested parties over another. Providing neutral or unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as **British American Tobacco** (GBR) should not suppress information about the numerous lawsuits that have been filed because of tobacco-related health concerns—even though such disclosure is damaging to the company.

Neutrality in rule-making has come under increasing attack. Some argue that the IASB should not issue pronouncements that cause undesirable economic effects on an industry or company. We disagree. Accounting rules (and the standard-setting process) must be free from bias, or we will no longer have credible financial statements. Without credible financial statements, individuals will no longer use this information. An analogy demonstrates the point: Many individuals bet on boxing matches because such contests are assumed not to be fixed. But nobody bets on wrestling matches. Why? Because the public assumes that wrestling matches are rigged. If financial information is biased (rigged), the public will lose confidence and no longer use it.

Free from Error. An information item that is **free from error** will be a more accurate (faithful) representation of a financial item. For example, if **UBS** (CHE) misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error. This is because most financial reporting measures involve estimates of various types that incorporate management's judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. And determination of depreciation expense requires estimation of useful lives of plant and equipment, as well as the residual value of the assets.

Enhancing Qualities

Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. These characteristics distinguish more-useful information from less-useful information. Enhancing characteristics, shown below, are comparability, verifiability, timeliness, and understandability.



Comparability. Information that is measured and reported in a similar manner for different companies is considered comparable. **Comparability** enables users to identify the real similarities and differences in economic events between companies. For example, historically the accounting for pensions in Japan differed from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies recorded pension cost as incurred. As a result, it is difficult to compare and evaluate the financial results of **Toyota** (JPN) or **Honda** (JPN) to **General Motors** (USA) or **Ford** (USA). Investors can only make valid evaluations if comparable information is available.

Another type of comparability, **consistency**, is present when a company applies the same accounting treatment to similar events, from period to period. Through such application, the company shows consistent use of accounting standards. The idea of consistency does not mean, however, that companies cannot switch from one accounting method to another. A company can change methods, but it must first demonstrate that the newly adopted method is preferable to the old. If approved, the company must then disclose the nature and effect of the accounting change, as well as the justification for it, in the financial statements for the period in which it made the change.³ When a change in accounting principles occurs, the auditor generally refers to it in an explanatory paragraph of the audit report. This paragraph identifies the nature of the change and refers the reader to the note in the financial statements that discusses the change in detail.⁴

Verifiability. **Verifiability** occurs when independent measurers, using the same methods, obtain similar results. Verifiability occurs in the following situations.

1. Two independent auditors count **PepsiCo's** inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset therefore can occur by simply counting the inventory (referred to as *direct verification*).
2. Two independent auditors compute PepsiCo's inventory value at the end of the year using the FIFO method of inventory valuation. Verification may occur by checking the inputs (quantity and costs) and recalculating the outputs (ending inventory value) using the same accounting convention or methodology (referred to as *indirect verification*).

Timeliness. **Timeliness** means having information available to decision-makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness. For example, if **Lenovo** (CHN) waited to report its interim results until nine months after the period, the information would be much less useful for decision-making purposes.

Understandability. Decision-makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful, there must be a connection (linkage) between these users and the decisions they make. This link, **understandability**, is the quality of information that lets reasonably informed users see its significance. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

³Surveys indicate that users highly value consistency. They note that a change tends to destroy the comparability of data before and after the change. Some companies assist users to understand the pre- and post-change data. Generally, however, users say they lose the ability to analyze over time. IFRS guidelines (discussed in Chapter 22) on accounting changes are designed to improve the comparability of the data before and after the change.

⁴In the United States, these provisions are specified in "Reports on Audited Financial Statements," *Statement on Auditing Standards No. 58* (New York: AICPA, April 1988), par. 34.

For example, assume that **Tomkins plc** (GBR) issues a three-months' report that shows interim earnings have declined significantly. This interim report provides relevant and faithfully represented information for decision-making purposes. Some users, upon reading the report, decide to sell their shares. Other users, however, do not understand the report's content and significance. They are surprised when Tomkins declares a smaller year-end dividend and the share price declines. Thus, although Tomkins presented highly relevant information that was a faithful representation, it was useless to those who did not understand it.

Thus, users of financial reports are assumed to have a reasonable knowledge of business and economic activities. In making decisions, users also should review and analyze the information with reasonable diligence. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it is too complex or difficult for some users to understand without assistance.⁵

⁵*The Conceptual Framework for Financial Reporting*, "Chapter 3, Qualitative Characteristics of Useful Financial Information" (London, U.K.: IASB, September 2010), paras. QC30–QC31.

(Note: Substitute this illustration for Illustration 2-7 on page 60.)

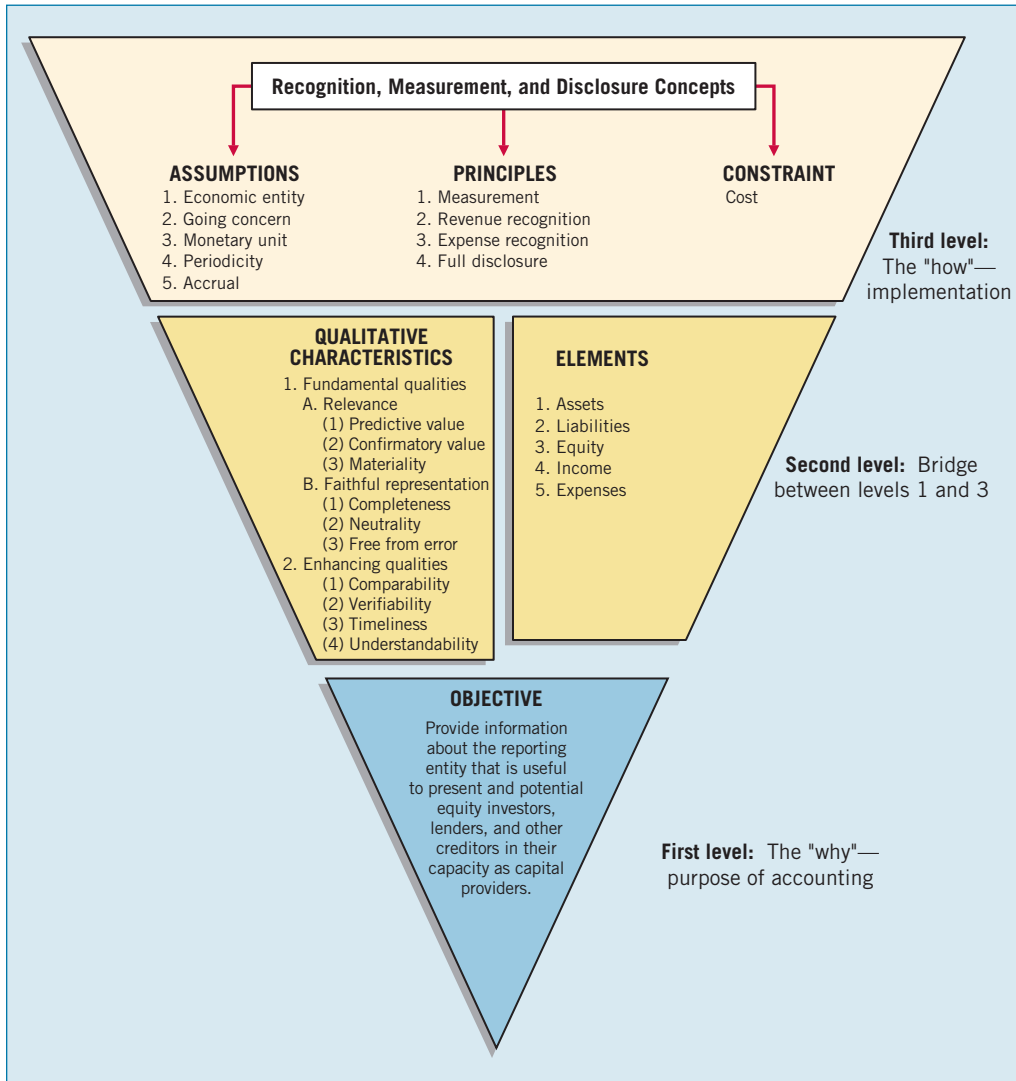


ILLUSTRATION 2-7
Conceptual Framework
for Financial Reporting

COMPREHENSIVE INCOME

The discussion in this section explains the recent amendments to IAS 1, “Presentation of Items of Other Comprehensive Income” (June 2011).

Background

As discussed in Chapter 4 of *Intermediate Accounting*, IFRS requires all income and expense items to be presented in the statement of comprehensive income. These items are presented in the income statement unless a standard requires presentation in a separate section called other comprehensive income (OCI). IFRS has not made distinctions among the various items presented in other comprehensive income. However, currently a range of very different items are presented in OCI, for example, the effect of changes in pension obligations, fixed asset revaluations, cash flow hedges, changes in the carrying amount of strategic equity investments, or foreign currency translation differences.

The lack of distinction between different items in OCI reflects the absence of agreement among users and preparers about which items should be presented in OCI and which should be part of income. For instance, a common misunderstanding is that the split between net income and OCI is on the basis of realized versus unrealized gains. This is not, and has never been, the case. This lack of a consistent basis for determining how items should be presented has led to the somewhat inconsistent use of OCI in IFRS.

To address this issue, the IASB recently issued guidance to group items presented in OCI on the basis of whether they might at some point be reclassified (“recycled”) from OCI to net income. Specifically, companies must classify OCI elements into two groups:

- Items that will not be reclassified subsequently to income; and
- Items that will be reclassified subsequently to income when specific conditions are met.

Again, the objective of this change is to clarify the effects these items may have on income in the future.

Convergence with U.S. GAAP

GAAP and IFRS have differed on the presentation of OCI items. GAAP had not required OCI items to be presented in the statement of comprehensive income but allows them to be incorporated in the statement of changes in equity or in the notes. This makes it difficult to identify and understand the nature of those gains and losses. These different approaches also make it difficult for users to compare financial statements prepared in accordance with GAAP and those prepared in accordance with IFRS.

The FASB has amended GAAP to require net income and other comprehensive income to be presented in either one statement or two continuous statements, with items of net income presented separately. This change in GAAP converges to the treatment under IFRS and makes it easier for users to compare the financial statements prepared in accordance with GAAP with those prepared according to IFRS. The new IASB and FASB guidance does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. Thus, there remain differences between GAAP and IFRS in this regard. The new IASB requirements on classification of OCI elements should make it easier to compare statements of comprehensive income prepared under IFRS and GAAP.

Summary

The FASB and IASB have been working on projects that will potentially increase the number of items that may be reported in other comprehensive income (e.g., financial instruments and pensions projects, discussed later in this Update, as well as the volume and significance of items currently reported in other comprehensive income). Thus, the Boards have worked jointly on a limited-scope project to develop common requirements for the presentation of other comprehensive income in GAAP and IFRS. The following can be added to footnote 16 in Chapter 4.

As a result of a recent amendment to comprehensive income guidance, companies must classify OCI elements into two groups: (1) items that will not be reclassified subsequently to income (e.g., pension remeasurements), and (2) items that will be reclassified subsequently to income when specific conditions are met (e.g., unrealized gains or losses on derivatives used in a cash flow hedge). The objective of this change is to clarify the effects these items may have on income in the future.

FAIR VALUE MEASUREMENT

The discussion in this section relates to updated fair value measurement and disclosure guidance (a joint project with the FASB). This material supplements the discussion throughout the textbook when measurement is based on fair value.

Background

Some IFRSs require or permit entities to measure or disclose the fair value of assets, liabilities, or their own equity instruments. Fair value measurement guidance has been developed over a number of years within numerous standards. As a result, IFRSs in many cases did not articulate a clear measurement or disclosure objective. In addition, some IFRSs contained limited information about how to measure fair value, whereas others contained extensive guidance about fair value measurement and disclosure, which was not always consistent across the standards. Furthermore, the global financial crisis emphasized the importance of having common fair value measurement and disclosure requirements to provide clear and consistent guidance for measuring fair value and addressing valuation uncertainty in markets that are no longer active. Such fair value guidance should also increase the transparency of fair value measurements by requiring detailed disclosures about fair values derived using models.

In response to these deficiencies in fair value reporting in IFRS, the IASB, in May 2011, issued *IFRS 13, Fair Value Measurement*. This project was initiated in 2005 as part of the IASB's joint efforts with the FASB to create a common set of high-quality global accounting standards.¹ As a result of this joint work, IFRS and GAAP are now converged. The goals of the fair value measurement project were:

1. To reduce complexity and improve consistency in the application of fair value measurement principles by having a single set of requirements for all fair value measurements;
2. To communicate the measurement objective more clearly by clarifying the definition of fair value;
3. To improve transparency by enhancing disclosures about fair value measurements; and
4. To increase the convergence of IFRS and GAAP.

In brief, *IFRS 13* defines fair value, sets out in a single IFRS a framework for measuring fair value, and requires disclosures about fair value measurements. *IFRS 13* applies when other IFRSs require or permit fair value measurements. However, it does not introduce any new requirements to measure an asset or a liability at fair value, change what is measured at fair value in IFRS, or address how to present changes in fair value in the financial statements (e.g., in income or other comprehensive income).

Fair Value Measurement Guidance

Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Fair value is therefore a market-based measure. Recently, IFRSs have increasingly called for use of fair value measurements in the financial statements. This is often

¹ The FASB issued a standard on fair value in 2006 (*Fair Value Measurement*; FASB ASC 820-10). The IASB's work on fair value measurement began with issuance of the FASB standard as an exposure draft. Feedback from IASB constituents was used by the FASB to update its fair value guidance.

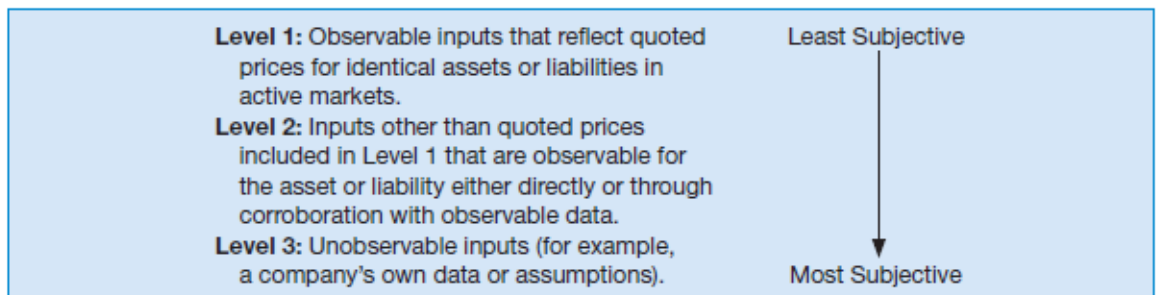
referred to as the **fair value principle**. Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries.

For example, companies report many financial instruments, including derivatives, at fair value. Certain industries, such as brokerage houses and mutual funds, prepare their basic financial statements on a fair value basis. At initial acquisition, historical cost equals fair value. In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Thus, fair value measures or estimates often provide more relevant information about the expected future cash flows related to the asset or liability. For example, when long-lived assets decline in value, a fair value measure determines any impairment loss. The IASB believes that fair value information for financial assets and financial liabilities is more relevant to users than historical cost. Fair value measurement, it is argued, provides better insight into the value of these assets and liabilities (its financial position) and a better basis for assessing future cash flow prospects.

Fair Value Hierarchy

As discussed, use of fair value in financial reporting is increasing. However, measurement based on fair value introduces increased subjectivity into accounting reports when fair value information is not readily available. To increase consistency and comparability in fair value measures, the IASB established a fair value hierarchy that provides insight into the priority of valuation techniques to use to determine fair value. As shown in Illustration UP-1, the fair value hierarchy is divided into three broad levels.

ILLUSTRATION
UP-1
(FAIR VALUE
MEASUREMENT)
Fair Value Hierarchy



As Illustration UP-1 indicates, Level 1 is the least subjective because it is based on quoted prices, like a closing share price in the *Financial Times*. Level 2 is more subjective and would rely on evaluating similar assets or liabilities in active markets. At the most subjective level, Level 3, much judgment is needed based on the best information available, to arrive at a relevant and representationally faithful fair value measurement. It is easy to arrive at fair values when markets are liquid with many traders, but fair value answers are not readily available in other situations. For example, how do you value the mortgage-backed assets of lenders, like **Société Générale** (FRA) and **Barclays** (GBR), given that the market for these securities has essentially disappeared? A great deal of expertise and sound judgment will be needed to arrive at appropriate answers. IFRSs also provide guidance on estimating fair values when market-related data are not available. In general, these valuation issues relate to Level 3 fair value measurements. These measurements may be developed using expected cash flow and present value techniques, as discussed in Chapter 6 of the textbook.

Fair Value Disclosure Examples

As indicated, the IASB believes that fair value information is relevant for making effective business decisions. However, others express concern about fair value measurements for two reasons: (1) the lack of reliability related to the fair value

measurement in certain cases, and (2) the ability to manipulate fair value measurements to achieve financial results inconsistent with the underlying economics of the situation.

The Board recognizes these concerns and has introduced the fair value hierarchy to provide a sound conceptual basis for disclosure of fair value information. Specifically, under *IFRS 13*, for major groups of assets and liabilities, companies must disclose: (1) the fair value measurement and (2) the fair value hierarchy level of the measurements as a whole, classified by Level 1, 2, or 3. Given the judgment involved, it follows that the more a company depends on Level 3 to determine fair values, the more information about the valuation process the company will need to disclose. Some of the disclosures in *IFRS 13* were already required elsewhere in IFRSs. For example, the fair value disclosures in *IFRS 7* (some of which were added in March 2009 in response to the global financial crisis) were relocated to *IFRS 13*. In addition, some IFRSs already require disclosure of the valuation techniques and inputs used in a fair value measurement and reconciliations of opening balances to closing balances (although on a broader level than the Level 3 reconciliation).

The main aspects of the disclosure requirements for fair value measurements categorized within Level 3 of the fair value hierarchy include the following:

- Reconciliation from opening to closing balances (which was required by *IFRS 7* for financial instruments);
- Quantitative information about the significant inputs used in the valuation technique(s);
- Valuation processes used by the company; and
- Sensitivity to changes in significant unobservable inputs (a narrative discussion for all fair value measurements and a quantitative analysis for financial instruments).

Examples of representative fair value disclosures under *IFRS 13* are provided in the following sections.

Disclosure of Fair Value Information: Financial Instruments

One requirement related to fair value disclosure is that both the cost and the fair value of all financial instruments be reported in the notes to the financial statements. This enables readers of the financial statements to understand the fair value of the company's financial instruments and the potential gains and losses that might occur in the future as a result of these instruments.

The Board also decided that companies should disclose information that enables users to determine the extent of usage of fair value and the inputs used to implement fair value measurement. Two reasons for additional disclosure beyond the simple itemization of fair values are:

1. Differing levels of reliability exist in the measurement of fair value information; it therefore is important to understand the varying risks involved in measurement. It is difficult to incorporate these levels of uncertainty into the financial statements. Disclosure provides a framework for addressing the qualitative aspects related to risk and measurement.
2. Changes in the fair value of financial instruments are reported differently in the financial statements, depending upon the type of financial instrument involved and whether the fair value option is employed.

Note disclosure provides an opportunity to explain more precisely the impact that changes in the value of financial instruments have on financial results. In assessing the inputs, the Board recognizes that the reliability of the fair value measurement is of extreme importance. Many financial instruments are traded in active markets, and their valuation is not difficult. Other instruments are complex and/or trade in illiquid markets. When valuation is difficult, then the disclosures must present classifications within the fair value hierarchy

Illustration UP-2 is an example of a fair value note disclosure for Sabathia Company. It includes both the fair value amounts and the reliability level. (A similar disclosure would be presented for liabilities.)

**ILLUSTRATION
UP-2
(FAIR VALUE
MEASUREMENT)**

Fair Value
Disclosure

SABATHIA COMPANY NOTES TO THE FINANCIAL STATEMENTS				
(\$ in 000s)	Fair Value Measurements at Reporting Data Using			
	Fair Value 12/31/12	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Trading securities	\$115	\$105	\$10	
Available-for-sale securities	75	75		
Derivatives	60	25	15	\$20
Venture capital investments	10			10
Total	<u>\$260</u>	<u>\$205</u>	<u>\$25</u>	<u>\$30</u>

For assets and liabilities measured at fair value and classified as Level 3, a reconciliation of Level 3 changes for the period is required. In addition, companies should report an analysis of how Level 3 changes in fair value affect total gains and losses and their impact on net income. Illustration UP-3 is an example of this disclosure.

**ILLUSTRATION
UP-3
(FAIR VALUE
MEASUREMENT)**

Level 3 Fair Value
Disclosure

SABATHIA COMPANY NOTES TO THE FINANCIAL STATEMENTS			
(\$ in 000s)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Derivatives	Venture Capital Investments	Total
Beginning balance	\$14	\$11	\$25
Total gains or losses (realized/unrealized)			
Included in earnings (or changes in net assets)	11	(3)	8
Included in other comprehensive income	4		4
Purchases, issuances, and settlements	(7)	2	(5)
Transfers in and/or out of Level 3	(2)		(2)
Ending balance	<u>\$20</u>	<u>\$10</u>	<u>\$30</u>
The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	<u>\$7</u>	<u>\$2</u>	<u>\$9</u>
Gains and losses (realized and unrealized) included in earnings (or changes in net assets) for the period (above) are reported in trading revenues and in other revenues as follows.			
	Trading Revenues	Other Revenues	
Total gains or losses included in earnings (or changes in net assets) for the period (as shown in the table above)	<u>\$11</u>	<u>\$(3)</u>	
Change in unrealized gains or losses relating to assets still held at reporting date	<u>\$7</u>	<u>\$2</u>	

Sabathia Company's disclosure provides to the user of the financial statements an understanding of the following:

1. The carrying amount and the fair value of the company's financial instruments segregated by level of reliability. Thus the reader of the financial statements has a basis for judging what credence should be given to the fair value amounts.
2. For Level 3 financial instruments, a reconciliation of the balance from the beginning to the end of the period. This reconciliation enables the reader to understand the composition of the change. It is important because these calculations are most affected by subjective estimates and could be subject to manipulation.
3. The impact of changes in fair value on the net assets of the company from one period to the next.

Disclosure of Quantitative and Qualitative Information

The disclosure in Illustration UP-4 provides an example quantitative and qualitative disclosures related to Level 3 fair value measurement.

**ILLUSTRATION
UP-4
(FAIR VALUE
MEASUREMENT)**
Quantitative
Information about
Level 3 Fair Value
Measurements

(\$ in millions)	Fair Value at 12/31/2012	Valuation Technique(s)	Unobservable Input	Range (Weighted-Average)
Residential mortgage-backed securities	125	Discounted cash flow	Constant prepayment rate Probability of default Loss severity	3.5%–5.5% (4.5%) 5%–50% (10%) 40%–100% (60%)
Collateralized debt obligations	35	Consensus pricing	Offered quotes Comparability adjustments (%)	20–45 –10%–+15% (+5%)
Direct venture capital investments: Health care	53	Discounted cash flow	Weighted-average cost of capital Long-term revenue growth rate Long-term pretax operating margin Discount for lack of marketability ^a Control premium ^a	7%–16% (12.1%) 2%–5% (4.2%) 3%–20% (10.3%) 5%–20% (17%) 10%–30% (20%)
		Market-comparable companies	EBITDA multiple ^b Revenue multiple ^b Discount for lack of marketability ^a Control premium ^a	6.5–12 (9.5) 1.0–3.0 (2.0) 5%–20% (10%) 10%–20% (12%)
Credit contracts	38	Option model	Annualized volatility of credit ^c Counterparty credit risk ^d Own credit risk ^d	10%–20% 0.5%–3.5% 0.3%–2.0%

^aRepresents amounts used when the reporting entity has determined that market participants would take into account these premiums and discounts when pricing the investments.
^bRepresents amounts used when the reporting entity has determined that market participants would use such multiples when pricing the investments.
^cRepresents the range of the volatility curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.
^dRepresents the range of the credit default swap spread curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.
(Note: For liabilities, a similar table should be presented.)

Summary

We presently have a “mixed-attribute” system that permits the use of historical cost and fair value. Although the historical cost principle continues to be an important basis for valuation, recording and reporting of fair value information is increasing. The recent measurement and disclosure guidance in *IFRS 13* should increase consistency and comparability when fair value measurements are used in the financial statements and related notes. It also represents another step toward convergence of GAAP and IFRS. As the former chair of the IASB noted, the new fair value guidance “marks the completion of a major convergence project and is a fundamentally important element of our joint response to the global crisis. The result is clearer and more consistent guidance on measuring fair value, where its use is already required.”

OFFSETTING

In this section, we discuss the IASB's new guidance on offsetting (or netting) of financial assets and liabilities: Offsetting Financial Assets and Liabilities: Amendments to IAS 32 (IASB: December 2011) and Disclosures—Financial Assets and Liabilities: Amendments to IFRS 7 (IASB: December 2011). This discussion is relevant to discussions in Chapters 7 (Cash and Receivables), 13 (Current Liabilities), and 17 (Investments).

Background

Why are accounts payable not offset against cash on the statement of financial position? Or, why is long-term debt used to finance equipment not netted against the equipment on the statement of financial position? The rationale: Offsetting of recognized assets and recognized liabilities detracts from the ability of users to understand the transactions and conditions that have occurred and to assess the company's future cash flows. In other words, providing information on assets, liabilities, and equity helps users to compute rates of return and evaluate capital structure. As a result, the IASB does not permit the reporting of summary accounts alone (e.g., total assets, net assets, and total liabilities). Instead, companies should report and classify individual items in sufficient detail to permit users to assess the amounts, timing, and uncertainty of future cash flows. As indicated in *Intermediate Accounting*, the objective of financial reporting requires providing information about the economic resources (assets) and the claims against these resources (liabilities). Netting assets and liabilities limits a user's ability to assess the future economic benefits and obligations. It therefore becomes difficult to assess a company's financial strength and weakness. In short, offsetting hides the existence of assets and liabilities, making it difficult to evaluate liquidity, solvency, and financial flexibility.

Debate over Offsetting

To be consistent with the objective of financial reporting, the IASB presently restricts the use of offsetting to a very limited set of circumstances. The transaction in which offsetting generally takes place occurs in the derivative area. The issue is whether companies with derivative transactions, which are subject to a master netting agreement, can present the derivatives on a net basis. IFRSs favor a gross approach, where both the asset and liability are reported on the statement of financial position and not netted together. However, under GAAP, companies are now permitted to net the asset and liability related to these types of contracts. In response to this diversity in guidance, in 2010 the IASB and FASB agreed to work on a project to develop common criteria for offsetting on the statement of financial position under IFRS and GAAP.

Preliminary decisions in that project would require a company to offset a recognized financial asset and a recognized financial liability only if a company (1) has an unconditional right of offset and (2) intends to either settle the asset and liability on a net basis or realize that asset and settle the liability simultaneously. The right of offset must be legally enforceable in all circumstances. Due to the nature of most master netting arrangements, the conditions for offsetting under the proposed rules would no longer be met for most U.S. companies. As a result, statement of financial positions (particularly for financial institutions) would be substantially larger as the gross asset and gross liability of the derivative transaction would have to be reported.

The FASB received significant push-back from some of its constituents (particularly financial institutions) to these proposed rules. As a result, to date the Boards have not been able to agree on a converged standard. However, the Boards acknowledge that differences in the guidance for offsetting reduce the comparability of statements of

financial position prepared under GAAP and IFRS. Furthermore, users of financial statements requested that the differences should be addressed expeditiously. In response to those requests, the FASB and the IASB have issued joint requirements that will enhance current disclosures.¹

Converged Disclosure Guidance

The new disclosure rules require companies to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position, and instruments and transactions subject to an agreement similar to a master netting arrangement. In general, the rules apply to derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements.

The objective of the disclosures is to provide information to enable users of financial statements to evaluate the effect or potential effect of netting arrangements on financial position. This includes the effect or potential effect of **rights of setoff** associated with a company's recognized assets and recognized liabilities covered by the standard. To meet the objective, a company must disclose at the end of the reporting period the following quantitative information separately for assets and liabilities:

- (a) The gross amounts of those recognized assets and those recognized liabilities.
- (b) The amounts offset in the statement of financial position.
- (c) The net amounts, after taking account of the amounts in (a) and (b) (which should be the same amounts presented in the statement of financial position).
- (d) The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in (b). An example of these items are (1) recognized financial instruments and other derivative instruments that management makes an accounting policy election not to offset, or (2) the amounts related to financial collateral (including cash collateral).
- (e) The net amount after deducting the amounts in (d) from the amounts in (c).

The information should be presented in a tabular format, separately for assets and liabilities (unless another format is more appropriate). The table in Illustration UP-1 (on the next page) provides an example of a tabular disclosure that meets the objective for the new rule when applied to financial and derivative assets.

¹ Based on input from its constituencies on the offsetting project, the IASB issued limited amendments to its standard on offsetting to clarify the meaning of a "legally enforceable right" and criteria for meeting the "intent to settle" requirement in IFRS [*Offsetting Financial Assets and Liabilities: Amendments to IAS 32* (IASB: December 2011)].

**ILLUSTRATION
UP-1
(OFFSETTING)**

Disclosure of
Offsetting

\$ million						
As of December 31, 2012	(i)	(ii)	(iii) = (i) – (ii)	(iv)		(v) = (iii) – (iv)
Description	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets Presented in the Statement of Financial Position	Gross Amounts Not Offset in the Statement of Financial Position		Net Amount
				Financial Instruments	Cash Collateral Received	
Derivatives	\$ 100	\$ (90)	\$ 10	\$ —	\$ —	\$ 10
Reverse repurchase, securities borrowing, and similar arrangements	90	—	90	(90)	—	—
Other financial instruments	—	—	—	—	—	—
Total	<u>\$ 190</u>	<u>\$ (90)</u>	<u>\$ 100</u>	<u>\$ (90)</u>	<u>\$ —</u>	<u>\$ 10</u>

Amendments to *IAS 19 (Employee Benefits)*

The following section summarizes the recent amendment to IAS 19 (Employee Benefits). We have developed a complete replacement chapter that fully incorporates the provisions of amended *IAS 19*. The new Chapter 20 (including end-of-chapter homework) can be accessed at the book's companion website at www.wiley.com/college/kieso.

Background

The accounting for pensions and other postretirement benefit plans is a challenging area for accounting standard-setters. In particular, defined benefit plans—which entail company promises to pay uncertain benefits in the future—give rise to large and uncertain costs for many companies. Estimating these costs can be complex. Given the numerous estimates and judgments inherent in measuring the impact of defined benefit plans on companies' financial position and performance, it is difficult to meet the goal of providing investors and creditors the most useful information on the companies' commitments resulting from those plans and the potential impact of the performance of those plans.

One of the key issues in the accounting for defined benefit plans relates to deferred recognition of gains and losses arising from remeasurements. Prior to the amendments to *IAS 19*, options in the standards allowed (1) gains and losses to be recognized either in income or equity (OCI) and (2) gains and losses to be recognized in the period when they occurred or they could be deferred. As a result of these options, it is difficult to compare companies with similar obligations. The option to defer recognition of some changes could prevent users from gaining a clear picture of the gains and losses that arose in the current period. In addition, the funded status of the plan (reflecting the net of pension assets and liabilities) was not reported in the statement of financial position.

New Measurement and Recognition Guidance

The recent amendments to *IAS 19* address these issues by removing deferral options and prescribing presentation of pension assets and liabilities. First, companies must report any deficit or surplus in a plan (funded status) on their statement of financial position (similar to GAAP). With respect to removal of deferrals, the amendments remove from *IAS 19* the option allowing companies to defer some gains and losses that arise from defined benefit plans (the "corridor approach"). As a result, companies must recognize these changes as they occur. In addition, the amendments eliminate options for presenting gains and losses. Rather, pension expense elements arising from service and finance costs are recorded in income, and remeasurements (of the pension asset and liability) are recorded in OCI.

As indicated, the change in the net defined benefit liability or asset is disaggregated into the following components:

- **Service cost**—the additional liability that arises from employees providing service during the period;
- **Net interest**—the interest expense on the net defined benefit liability or interest income on the net defined benefit asset; and
- **Remeasurements**—other changes in the value of the defined benefit obligation, such as changes in estimates, amendments (amendments for prior service are recognized immediately), and other changes in the value of plan assets. Amounts recorded in OCI are not "recycled" to income via amortization in subsequent periods.

An important difference is the substitution of a single net interest component for the expected return on assets and interest costs on the defined benefit liability. Thus, the net defined benefit liability or asset is equivalent to an amount

owed to or from the plan (similar to a receivable or payable). The IASB decided on this approach because an underfunded plan will result in interest expense and an overfunded plan will result in interest income, reflecting the financing effect of the amount owed to or from the plan.

Note that under the prior IFRS, a pension liability could result in net finance income if the expected return on plan assets exceeded the interest cost on the defined benefit obligation. In addition, the returns on assets with higher risk were reflected in income (with a higher expected return and lower pension expense), while the costs of taking that risk (unexpected gains and losses) were reflected in OCI. The IASB believes the approach in the amended *IAS 19* is simpler, more understandable, and better represents the underlying economics of the change attributable to the passage of time. Indeed, the FASB indicates it will consider the *IAS 19* amendments when it restarts its project on pensions and other postemployment benefits.

PROPOSED PROJECTS

As discussed in *Intermediate Accounting*, the IASB and FASB have been working on a number of projects to reduce differences in IFRS and GAAP. The objective is to develop a single set of high-quality standards for use by companies around the world. The three projects discussed in this section—financial instruments, revenue recognition, and leases—have been identified by the Boards as significant topics for which the accounting under GAAP and IFRS could be improved. At the time that this Update is going to press, the Boards are in the process of redeliberating and receiving input from their constituencies on these projects. Revised exposure drafts are yet to be issued for some of the projects later in 2012, with final standards not expected until late 2012 or early 2013. Thus, the final standards issued may differ from the discussions below. While effective dates for these projects will likely not be earlier than 2016, instructors and students may still want to begin developing understanding of the proposed accounting in these important areas.

FINANCIAL INSTRUMENTS

This section contains a summary of the IASB's project on financial instruments, which is a joint project with the FASB. This discussion relates to discussions of loans and impairments in Chapter 7 (Cash and Receivables), financial liabilities in Chapter 14 (Long-Term Liabilities), and investments in Chapter 17 (Investments).

Background

As discussed in *Intermediate Accounting*, a **financial instrument** is cash, an equity investment of another company, or a contractual right to receive cash from (or obligation to pay cash to) another party (e.g., loans, receivables, and bonds). The accounting for cash is relatively straightforward and is discussed in Chapter 7. The accounting and reporting for equity and debt investments, as discussed in the opening story of Chapter 17, is extremely contentious, particularly in light of the credit crisis in the latter part of 2008. Some users of financial statements support a single measurement—fair value—for all financial instruments. They view fair value as more relevant than other measurements in helping investors assess the effect of current economic events on the future cash flows of the asset. In addition, they believe that the use of a single method promotes consistency in valuation and reporting on the financial asset, thereby improving the usefulness of the financial statements. Others disagree. They note that many investments are not held for sale but rather for the income they will generate over the life of the investment. They believe cost-based information (referred to as *amortized cost*) provides the most relevant information for predicting future cash flows in these cases. Others express concern that using fair value information to measure financial assets is unreliable when markets for the investments are not functioning in an ordinary fashion.

The IASB and FASB have worked together on a project to improve and simplify the accounting for financial instruments. However, the Boards have worked on different project timelines. The IASB has addressed the project in parts. It issued a new standard on classification and measurement [*IFRS 9, Financial Instruments* (November 2009)]. The discussion in Chapter 17 (Investments) of *Intermediate Accounting* reflects the guidance in *IFRS 9*. The IASB is now

deliberating issues related to impairment and hedge accounting.¹ The discussion in the following sections reflects decisions made at the time this Update is going to press. These decisions may be changed in the final standard.

Classification and Measurement—A Closer Look

The proposed guidance applies to financial assets and liabilities, including loans and receivables; investments in debt and equity securities; and the debt issued by a company. As discussed in Chapter 17 of *Intermediate Accounting*, in general, IFRS requires that a company determines how to measure its financial assets based on two criteria:

- The company's business model for managing its financial assets; and
- The contractual cash flow characteristics of the financial asset.

If a company has (1) a business model whose objective is to hold assets in order to collect contractual cash flows and (2) the contractual terms of the financial asset provides specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, then the company should use amortized cost. For example, assume that **Mitsubishi** (JPN) purchases a bond investment that it intends to hold to maturity. Its business model for this type of investment is to collect interest and then principal at maturity. The payment dates for the interest rate and principal are stated on the bond. In this case, Mitsubishi accounts for the investment at amortized cost. If, on the other hand, Mitsubishi purchased the bonds as part of a trading strategy to speculate on interest rate changes (a trading investment), then the debt investment is reported at fair value. As a result, only debt investments such as receivables, loans, and bond investments that meet the two criteria above are recorded at amortized cost.

All other debt investments are recorded and reported at fair value. Equity investments are generally recorded and reported at fair value. Equity investments do not have a fixed interest or principal payment schedule and therefore cannot be accounted for at amortized cost. In summary, companies account for investments based on the type of security, as indicated in Illustration UP-1.

ILLUSTRATION
UP-1
(FINANCIAL
INSTRUMENTS)
Summary of
Investment
Accounting
Approaches

Type of Investment	Assessment of Accounting Criteria	Valuation Approach
Debt (Section 1)	Meets business model (held-for-collection) and contractual cash flow tests.	Amortized cost
	Does not meet the business model test (not held-for-collection).	Fair value
Equity (Section 2)	Does not meet contractual cash flow test.	Fair value*

*For some equity investments for which the investor exercises some control over the investee, use the equity method.

As indicated, the general measurement principle is either fair value or amortized cost. If a company has both a business strategy whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset provides specified dates to cash flows that are solely payments of principal and interest on the principal

¹ Rather than breaking up the financial instruments project into parts, the FASB attacked the project in one piece. The FASB issued a comprehensive exposure draft in 2010 and has been examining the comments received on that exposure draft. The FASB has been consulting with the IASB on this project, and it plans to issue a final (hopefully converged) standard on the classification and measurement, impairment, and hedging as they relate to financial instruments in 2013.

amount outstanding, then the company should use amortized cost. If the criteria for measurement at amortized cost are not met, then the financial instruments are valued and accounted for at fair value.

Impairment

A significant accounting weakness revealed during the financial crisis relates to the accounting for loan losses (or allowance for doubtful accounts). The concern is that the existing IFRS results in allowances for loan loss that tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle (the “too little, too late” concern). Therefore, the IASB (with the FASB) is now working to develop a standard that ensures that the allowance for loan loss balance is sufficient to cover all estimated credit losses for the remaining life of an instrument.

The Boards had agreed that a company should recognize in net income an impairment when it does not expect to collect all contractual amounts due for originated financial assets or all amounts originally expected to be collected for purchased financial assets. Furthermore, the Boards indicate that it is inappropriate to allocate (defer) an impairment loss over the life of a financial asset. In other words, if a company does not expect to collect all amounts due, a loss exists and should be recognized immediately. Many oppose this conservative approach to impairment. In response to concerns about the impairment approach described above, the Boards are working on another approach. This approach is called the “three bucket” approach and is described as follows.

Bucket 1. Financial assets evaluated collectively for impairment that do not meet the criteria for Bucket 2 or 3. That is, this bucket includes loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not specific to either a group of loans or a specific loan.

Bucket 2. Financial assets affected by the occurrence of events that indicate possible future defaults. However, the specific debt instruments in danger of default have not yet been identified.

Bucket 3. Financial assets for which information is available that specifically identifies that credit losses are expected to occur, or have already, on individual debt instruments.

In general, here is how the model works. Financial assets would start out in Bucket 1 with reserves equal to 12 months of expected losses. Then, financial assets move to Bucket 2 or 3 and reserves increase to reflect expected losses over the life of those assets if (1) the credit quality deteriorates after origination or purchase, and (2) there is an expectation that substantially all of the contractual cash flows will not be recovered. Financial assets with reserves determined at a portfolio level would be categorized in Bucket 2 and those for which reserves are determined at the individual instrument level would be categorized in Bucket 3. If creditworthiness subsequently improves (based on expectations over the lifetime of the financial assets), reserves can be adjusted to again equal 12 months of expected losses (that is, the financial assets could move back to Bucket 1). Thus, the allowance balance for debt instruments in Buckets 2 and 3 are estimates of remaining lifetime expected losses.

This model represents a significant change from current practice. However, the model has gained support because the allowance captures three different phases of deterioration in credit quality. In addition, in contrast to current GAAP, which is based on an “incurred loss” model, estimated loan losses are recognized earlier. That is, GAAP generally only records loan losses on loans in Bucket 1 of the proposed model.

Discussions to date have focused on loans and trade receivables with some preliminary considerations for debt securities. For trade receivables, the Boards are exploring whether new guidance is needed. For those with a significant financing element, the loan model would be followed. It’s less clear, though, which model should be used for trade receivables that do not have a significant financing element—much more common for companies other than banks. For

these trade receivables, the Boards are considering whether reserves should be recorded using an incurred loss model (similar to existing guidance) or whether an expected loss model is more appropriate.

Below is a summary of decisions reached on impairment issues **prior to development of the “three-bucket” approach. These issues may be reconsidered by the Boards at future meetings if deemed necessary.**

- **Uncollectibility.** A financial asset is considered uncollectible if the company has no reasonable expectation of recovery. Therefore, a company writes off a financial asset or part of a financial asset in the period in which the company has no reasonable expectation of recovery of the financial asset (or part of the financial asset). A write-off is defined as “a direct reduction of the amortized cost of a financial asset resulting from uncollectibility.”
- **Estimating expected losses.** A company should use the best available and supportable information at the date of estimation (historical, current, and forecasted) to estimate expected losses. Expected losses should be estimated with the objective of an expected value. An expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability weighted-average. Expected losses should be measured as all shortfalls in cash flows (both principal and interest) on a discounted basis. That is, the measurement of expected losses should reflect the effect of discounting.
- **Unwinding the discounting of expected credit losses.** The effect of unwinding the discounting of expected credit losses (through amortization) should be included in bad debt expense on the statement of comprehensive income.
- **Interest income recognition.** Interest income should be determined by applying the effective-interest rate to an amortized cost balance that is not reduced for credit impairment.

In summary, the Boards agree on the general conceptual elements of the three-bucket approach. They will continue to deliberate this model and plan to address the following issues in future meetings: (1) an approach for Bucket 1 with an overall objective of recognizing an impairment allowance equal to 12 months’ worth of expected losses based on initial expectations plus the full amount of any changes in expected credit losses, and (2) clear and well-defined indicators and criteria for when to transfer debt instruments among Buckets 1, 2, and 3.

Other Issues

The Boards have identified a number of other issues in the financial instruments project that must yet be resolved:

- Reclassification between categories is not permitted under the FASB proposal, even when there is a change in business strategy, because reclassifications reduce comparability and consistency between companies. *IFRS 9* allows reclassifications.
- Changes in fair value that have been recognized in OCI are recognized in net income (i.e., recycled) when these gains or losses are realized, either through sales or settlements. Historically, GAAP and IFRS have not always agreed on recycling of gains and losses in OCI to net income.

Hedge Accounting

The objective of the hedge accounting phase is to improve the usefulness of financial statements for users by fundamentally reconsidering the current hedge accounting requirements. The Board is considering hedge accounting of both financial and non-financial hedged items. An exposure draft, issued in December 2010, addresses general hedge

accounting. The IASB is continuing to redeliberate macro or portfolio hedge accounting, and the feedback received on the general hedge accounting model is important to the redeliberations for macro or portfolio hedges. The IASB plans to issue general hedge accounting guidance in the second half of 2012.²

Summary

The IASB and the FASB recently agreed to work on key differences that they have related to the classification and measurement of financial instruments. This development is good news as it appeared that the two Boards might differ on how to account and report financial instruments. As one example, the Boards have recently indicated that financial instruments should be measured at fair value through net income if the contractual cash flows are not solely payments for principal and interest. The FASB has been examining comments on its exposure draft issued in 2010. Based on its redeliberations (it currently plans to reexpose its financial instruments document later in 2012), the IASB plans to reexpose and solicit comments on its standard on classification and measurement (*IFRS 9*). A final (hopefully converged) standard will likely be issued in 2013.

² The FASB has not begun redeliberations on hedge accounting. However, the FASB has participated in the IASB's discussion of the feedback received on the IASB exposure draft and will consider the feedback during its reexamination. A final standard on hedge accounting is not expected until 2013.

REVENUE RECOGNITION

The discussion in this section addresses the IASB's joint project with the FASB on revenue, which is addressed in Chapter 18 (Revenue).

Background

Most revenue transactions pose few problems for revenue recognition. This is because, in many cases, the transaction is initiated and completed at the same time. However, not all transactions are that simple. For example, consider a customer who enters into a mobile phone contract with a company such as **Vodafone** (GBR). The customer is often provided with a package that may include a handset, free minutes of talk time, data downloads, and text-messaging service. In addition, some providers will bundle that with a fixed-line broadband service. At the same time, customers may pay for these services in a variety of ways, possibly receiving a discount on the handset and then paying higher prices for connection fees and so forth. In some cases, depending on the package purchased, the company may provide free applications in subsequent periods. How, then, should the various pieces of this sale be reported by Vodafone? The answer is not obvious.

It is therefore not surprising that a recent survey of financial executives noted that the revenue recognition process is increasingly more complex to manage, more prone to error, and more material to financial statements compared to any other area in financial reporting. The report went on to note that revenue recognition is a top fraud risk and that regardless of the accounting rules followed (IFRS or GAAP), the risk of errors and inaccuracies in revenue reporting is significant.¹

Indeed, both the IASB and the FASB indicate that the present state of reporting for revenue is unsatisfactory. IFRS is criticized because it lacks guidance in a number of areas. For example, IFRS has one basic standard on revenue recognition—*IAS 18*—plus some limited guidance related to certain minor topics. In contrast, GAAP has numerous standards related to revenue recognition (by some counts, well over 100), but many believe the standards are often inconsistent with one another. Thus, the accounting for revenues provides a most fitting contrast of the principles-based (IFRS) and rules-based (GAAP) approaches. While both sides have their advocates, the FASB and IASB recognize a number of deficiencies in this area.²

Unfortunately, inappropriate recognition of revenue can occur in any industry. Products that are sold to distributors for resale pose different risks than products or services that are sold directly to customers. Sales in high-technology industries, where rapid product obsolescence is a significant issue, pose different risks than sales of inventory with a longer life, such as farm or construction equipment, automobiles, trucks, and appliances.³ As a consequence, restatements for improper revenue recognition are relatively common and can lead to significant share price adjustments.

As a result, in June 2010 the IASB and the FASB issued an exposure draft on revenue recognition entitled *Revenue from Contracts with Customers*. The Boards received many comments on this exposure draft and have reached decisions on many of the issues related to the revenue recognition model. However, some parts of the model need further clarification. As a result, the Boards issued a revised exposure draft on this subject [*Revenue from Contracts with Customers*, Exposure Draft (January 4, 2012)]. The material presented here reflects this most recent exposure draft. It is likely that a final standard will be issued in late 2012.

¹See www.prweb.com/releases/RecognitionRevenue/IFRS/prweb1648994.htm.

²See, for example, "Preliminary Views on Revenue Recognition in Contracts with Customers," *IASB/FASB Discussion Paper* (December 19, 2008). Some of the problems noted are that GAAP has so many standards that at times they are inconsistent with each other in applying basic principles. In addition, even with the many standards, no guidance is provided for service transactions. Conversely, IFRS has a lack of guidance in certain fundamental areas such as multiple-deliverable arrangements, which are becoming increasingly common. In addition, there is inconsistency in applying revenue recognition principles to long-term contracts versus other elements of revenue recognition.

³Adapted from American Institute of Certified Public Accountants, Inc., *Audit Issues in Revenue Recognition* (New York: AICPA, 1999).

Revenue Recognition Model

The revenue recognition model proposed is a significant change from the present model of how revenue is recognized. The new model adopts an asset-liability approach, which is consistent with the conceptual framework approach to recognition. The Boards believe a contract-based model that measures changes in contract assets and liabilities is conceptually correct and will lead to a consistent approach to recognize revenue.

As indicated in the textbook, the revenue recognition model presently used is to recognize revenue (1) when it is probable that the economic benefits will flow to the company, and (2) when the benefits can be measured reliably. In the exposure draft, the revenue recognition model is different. It requires a company to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services. To apply this principle, a company:

1. Identifies the contract(s) with customers.
2. Identifies the separate performance obligations in the contract.
3. Determines the transaction price.
4. Allocates the transaction price to the separate performance obligation.
5. Recognizes revenue when the company satisfies each performance obligation.

Identifying the Contract(s) with Customers

A contract is defined as an agreement between two or more parties that creates enforceable rights or obligations. Contracts can be written, oral, or implied from customary business practice. Criteria are provided in the exposure draft to assess whether a contract has occurred between a company and its customers. In some cases, there may be multiple contracts related to a transaction, and segmentation may or may not occur depending on the circumstances.

Identifying the Separate Performance Obligations in the Contract

A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. In some cases, a company promises a bundle of goods or services. These goods or services should be accounted for separately only if certain conditions are met.

Determining the Transaction Price

Transaction price is the amount of consideration a company is entitled to receive in exchange for transferring goods or services to a customer. If the consideration is uncertain, the company must estimate the amount. The approaches followed to estimate this amount are either (1) a weighted-average amount of possible payments or (2) the most likely amount.

A second guideline is that companies should consider the time value of money if the contract includes a significant financing element. As a practical help, if the financing is less than one year, a company does not have to consider the time value of money.

Companies do not consider the effects of customer credit risk (that is, collectibility) when determining the transaction price. Instead, companies account for those effects by applying other FASB guidance on uncollectible accounts. Any corresponding amounts recognized in profit or loss would be presented both initially and subsequently as a separate line item adjacent to the revenue line item.

Allocating the Transaction Price to the Separate Performance Obligations

Companies should allocate to each separate performance obligation the amount of consideration the company expects to receive in exchange for satisfying that performance obligation. In general, the allocation is based on the relative standalone selling price of each service or good. If one of the standalone prices of a good or service is difficult to estimate, a residual approach is used. In a residual approach, companies take the total consideration and subtract the standalone value of goods or services that have a high degree of certainty. The remaining amount is then allocated to the remaining good or service.

Recognizing Revenue When the Company Satisfies Each Performance Obligation

The final step is the recognition of the revenue. A company should recognize revenue when it satisfies a performance obligation. This occurs by transferring the goods or services to the customer, which is when the customer obtains control of the promised good or service. The customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service.

Indicators that the customer has obtained control of a good are:

1. The customer has an unconditional obligation to pay.
2. The customer has legal title.
3. The customer has physical possession.
4. The customer has the risks and rewards of ownership of goods.

The recognition criteria for services is less straightforward, fairly complex, and beyond our discussion here. It should be noted that if the goods and services are separate performance obligations, the company should account for them separately. Otherwise, the company should account for the bundle of goods and services as a service.

Revenue Recognition Issues—Illustrations

The new proposed standard on revenue recognition has a substantial impact on Chapter 18 of *Intermediate Accounting*. As indicated earlier, the proposed standard requires a five-step approach. Companies first must identify contract(s) with customers and then determine the separate performance obligations within the contract(s). At this point, companies then estimate the transaction price and allocate the transaction price to the different performance obligations if appropriate. Revenue is then recognized when the performance obligation is satisfied by transferring control to the customer of the good or service. A number of examples are provided below to illustrate how revenue recognition will change in the future as a result of this proposed standard.

Identifying the Contract with the Customer

The first step in the revenue recognition process is to identify the contract with the customer. In most cases, this step is very straightforward. However, in some cases it will be necessary to determine whether the contract involves more than one performance obligation. These situations often develop when not only a product is being transferred but some type of service is provided as well.

The new exposure draft specifies that when either party to a contract has performed, the company should recognize the contract either as a contract asset or contract liability. If the right is unconditional, it should be reported as a receivable. The next two pages show three illustrations of these situations.⁴

⁴ The illustrations are adapted from *Proposed Accounting Standards Update (Revised)*, “Revenue from Contracts with Customers” (Norwalk, Conn.: FASB, November 14, 2011, and January 4, 2012), pages 74-75.

Illustration UP-1 (Revenue Recognition)
Basic Receivable Transaction

CONTRACTS AND RECOGNITION

Facts: On March 1, 2013, Margo Company enters into a contract to transfer a product to Soon Yoon on July 31, 2013. The contract is structured such that Soon Yoon is required to pay the full contract price of \$5,000 on August 31, 2013. Margo delivers the product to Soon Yoon on July 31, 2013.

Question: What entries should Margo Company make in regards to this contract in 2013?

Solution: No entry is required on March 1, 2013 because neither party has performed on the contract. That is, neither party has an unconditional right as of March 1, 2013. On July 31, 2013, Margo delivers the product and therefore should recognize revenue on that date as it received an unconditional right to consideration on that date. The journal entry to record this transaction (ignoring the cost of goods sold entry) is as follows.

July 31, 2013	
Accounts Receivable	5,000
Sales Revenue	5,000
August 31, 2013	
Cash	5,000
Accounts Receivable	5,000

Illustration UP-2 (Revenue Recognition)
Contract Liability and Receivable Transaction

CONTRACTS AND RECOGNITION

Facts: On March 1, 2013, Henly Company enters into a contract to transfer a product to Propel Inc. on July 31, 2013. It is agreed that Propel will pay the full price of \$10,000 in advance on April 1, 2013. The contract is non-cancelable. Propel, however, does not pay until April 15, 2013, and Henly delivers the product on July 31, 2013.

Question: What entries are required in 2013?

Solution: No entry is required on March 1, 2013, because neither party has performed on the contract. That is, neither party has an unconditional right as of March 1, 2013. On April 1, 2013, Propel agreed to pay the full price and therefore Henly has an unconditional right to those funds on that date. As a result, Henly should make the following entry on April 1, 2013.

April 1, 2103	
Accounts Receivable	10,000
Contract Liability	10,000

On receiving the cash on April 15, 2013, Henly records the following entry.

April 15, 2013	
Cash	10,000
Accounts Receivable	10,000

On satisfying the performance obligation on July 31, 2013, Henly records the following entry.

July 31, 2013	
Contract Liability	10,000
Sales Revenue	10,000

Henly Company records the receivable on April 1, 2013, because it has an unconditional right to those funds on that date. If the contract were cancelable, Henly would not make an entry on April 1 but would record a debit to Cash and credit to Contract Liability on April 15, 2013.

CONTRACT AND RECOGNITION

Facts: On January 1, 2013, Finn Company enters into a contract to transfer Product A and Product B to Kaufmann Co. for \$100,000. The contract specifies that payment of Product A will not occur until Product B is also delivered. In other words, payment will not occur until both Product A and Product B are transferred to Kaufmann. Finn determines that standalone prices are \$30,000 for Product A and \$70,000 for Product B. Finn delivers Product A to Kaufmann on February 1, 2013. On March 1, 2013, Finn delivers Product B to Kaufmann.

Question: What entries should Finn Company make in regards to this contract in 2013?

Solution: No entry is required on January 1, 2013, because neither party has performed on the contract. On February 1, 2013, Kaufmann records the following entry.

February 1, 2013	
Contract Asset	30,000
Sales Revenue	30,000

On February 1, Finn has satisfied its performance obligation and therefore reports revenue of \$30,000. However, it does not record an accounts receivable at this point because it does not have an unconditional right to receive the \$100,000 unless it transfers to Kaufmann Product B. When Finn transfers Product B on March 1, 2013, it makes the following entry.

March 1, 2013	
Accounts Receivable	100,000
Contract Asset	30,000
Sales Revenue	70,000

Contract Modifications

An additional major issue relates to a change in contract terms during the term of the contract; this is referred to as a contract modification. When a contract is modified, the company must determine whether a new performance obligation has occurred or whether it is a modification of the existing performance obligation. If it is a modification of an existing performance obligation, then the change is generally reported as a cumulative effect adjustment to revenue. An example of a contract modification for Heiser Construction is shown in Illustration UP-4 (on the next page).⁵

Identifying Separate Performance Obligations

A performance obligation is a promise in a contract to provide a product or service to a customer. This promise may be explicit, implicit, or possibly based on customary business practice. A company accounts for a separate performance obligation if it is distinct. A good or service is distinct if one of the following criteria is met: (a) the company regularly sells the good or service separately or (b) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. The question is: When is a distinct group of products or services bundled together and accounted for as one performance obligation?

The exposure draft indicates that a company should combine goods or services into a single performance contract if **both** of the following criteria are met.

1. The goods or services are highly interrelated and require the company to provide a significant service of integrating the goods or services into a combined item that the customer has contracted for.
2. The company significantly modifies or customizes the goods or services to fulfill the contract.

Examples of identifying separate performance obligations are discussed in the “Allocating the Transaction Price to Separate Performance Obligations” section later in this Update.

⁵ Illustration adapted from *Dataline: A Look at Current Financial Reporting Issues*, “Revenue from Contracts with Customers—The Proposed Revenue Standard Is Re-exposed,” No. 2011-35 PricewaterhouseCoopers [November 22, 2011 (Revised January 3, 2012)], page 5.

Illustration UP-4 (Revenue Recognition)
Contract Modification

CONTRACT MODIFICATION

Facts: Heiser Construction Company enters into a contract with a customer to build a customized house. The contract is a single performance obligation given the deliverable promised to the customer. Costs incurred to date in relation to total estimated costs to be incurred are the best measure of the pattern of transfer to the customer. The original transaction price in the contract was \$500,000 with estimated costs of \$400,000. The customer requests changes to the design midway through construction (\$200,000 of costs have been incurred). The modification increases the transaction price and estimated costs by \$100,000 and \$50,000, respectively.

Question: How much incremental revenue should be recorded as a result of this contract modification?

Solution: Heiser should account for the contract modification as if it were part of the original contract because the modification does not result in a separate performance obligation. Management should update its measurement of progress on the original contract to reflect the contract modification because the remaining goods and services are part of a single performance obligation that is partially satisfied at the modification date.

	<u>Original</u>	<u>Modification</u>	<u>Revised</u>
Transaction price	\$500,000	\$100,000	\$600,000
Estimated costs	400,000	50,000	450,000
Percent complete	50%		44%
Revenue to date	\$250,000		\$264,000
Incremental revenue (\$264,000 – \$250,000)			\$ 14,000

On the other hand, if the modification results in a separate performance obligation, then this performance obligation should be accounted for separately.

Determining the Transaction Price and Collectibility

The transaction price in a contract is often easily obtained because the customer agrees to pay a fixed amount of consideration to the company over a short period of time. In other contracts, the following factors must be considered.

1. Variable consideration.
2. Time value of money.
3. Non-cash consideration.
4. Consideration paid to a customer.

Variable Consideration. In some cases, the price of a good or service is dependent on future events. These future events might include discounts, rebates, credits, performance bonuses, or royalties. In these cases, the company must estimate the amount of variable consideration it will receive from the contract to determine the amount of revenue to recognize. One of two approaches should be used to estimate the variable consideration:

1. The expected value, which is a probability weighted amount.
2. The most likely amount in a range of possible amounts.

The expected value approach is shown in *Intermediate Accounting* in Chapter 6 (pages 337–338) to determine the liability for warranties. This same approach is used here to determine the amount of revenue to be recognized when variable consideration is involved.

It should be emphasized that variable consideration should be allocated to the performance obligation only if the company is reasonably assured that it will be entitled to that amount. In other situations, the most likely amount in a range of possible amounts should be used. For example, when the question is whether the company will receive a royalty payment of either \$1,000,000 or \$0, depending on a future event, the most likely amount should be used. These approaches are shown in Illustration UP-5 (on the next page).⁶

⁶ *Ibid.*, page 8.

ESTIMATING VARIABLE CONSIDERATION

Facts: Peabody Construction Company enters into a contract with a customer to build an asset for \$100,000 with a performance bonus of \$50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10 percent per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts the entity has performed previously, and management believes that such experience is predictive for this contract. Management estimates that there is a 60 percent probability that the contract will be completed by the agreed-upon completion date, a 30 percent probability that it will be completed one week late, and only a 10 percent possibility that it will be completed two weeks late.

Question: How should Peabody account for this revenue arrangement?

Solution: The transaction price should include management's estimate of the amount of consideration to which the entity will be entitled. Management has concluded that the probability-weighted method is the most predictive approach for estimating the variable consideration in this situation:

60% chance of \$150,000 =	\$ 90,000
30% chance of \$145,000 =	43,500
10% chance of \$140,000 =	<u>14,000</u>
	<u>\$147,500</u>

Thus, the total transaction price is \$147,500 based on the probability-weighted estimate. Management should update its estimate at each reporting date. Using a most likely outcome approach may be more predictive if a performance bonus is binary such that the entity earns either \$50,000 for completion on the agreed-upon date or nothing for completion after the agreed-upon date. In this scenario, if management believes that the entity will meet the deadline and estimates the consideration using the most likely outcome, the total transaction price would be \$150,000 (the outcome with 60% probability).

Time Value of Money. The time value of money must be considered if the contract involves a significant financing component. When a sales transaction involves a financing component, the fair value is determined either by measuring the consideration received or by discounting the payment using an imputed interest rate. The imputed interest rate is the more clearly determinable of either (1) the prevailing rate for a similar instrument of an issuer with a similar credit rating, or (2) a rate of interest that discounts the nominal amount of the instrument to the current sales price of the goods or services.

The company will report the effects of the financing either as interest expense or interest revenue. The example in Illustration UP-6 (on the next page) addresses this issue.

Non-Cash Consideration. When non-cash consideration is involved, revenue is generally recognized on the basis of the fair value of what is received. If this amount cannot be determined, revenue is determined based on the fair value of the good or service transferred.

Consideration Paid to a Customer. In some cases, companies include rebates or upfront payments when they transfer goods or services to customers. In most cases, the consideration paid to customers should be reflected as a reduction of revenue because it represents a discount on the goods or services transferred. This guidance is essentially the same as present GAAP and therefore no significant changes from present practice are expected.

Collectibility

Any time a company sells a product or provides a service on account, a collectibility issue occurs. That is, will the customer pay the promised consideration? Current GAAP requires that revenue be recognized only when collectibility is reasonably assured. However the new exposure draft permits companies to recognize revenue earlier even if collectibility is a problem. As indicated above, the exposure draft indicates that the company should report the revenue gross and then present an allowance for any impairment due to bad debts in a separate line adjacent to the revenue. Illustration UP-7 provides an example of this presentation.⁷

⁷ *Ibid.*, pages 10-11.

Illustration UP-6 (Revenue Recognition)
Extended Payment Terms

EXTENDED PAYMENT TERMS

Facts: On July 1, 2012, SEK Company sold goods to Grant Company for \$900,000 in exchange for a 4-year zero-interest-bearing note in the face amount of \$1,416,163. The goods have an inventory cost on SEK's books of \$590,000.

Questions: (a) How much revenue should SEK Company record on July 1, 2012? (b) How much revenue should it report related to this transaction on December 31, 2012?

Solution:

- (a) SEK should record revenue of \$900,000 on July 1, 2012, which is the fair value of the inventory in this case.
 (b) SEK is also financing this purchase and records interest revenue on the note over the 4-year period. In this case, the interest rate is imputed and is determined to be 12%. SEK records interest revenue of \$54,000 ($12\% \times 1/2 \times \$900,000$) at December 31, 2012.

The journal entry to record SEK's sale to Grant Company is as follows (ignoring the cost of goods sold entry).

July 1, 2012

Notes Receivable	1,416,163	
Sales Revenue		1,416,163

SEK makes the following entry to record interest revenue.

December 31, 2012

Notes Receivable	54,000	
Interest Revenue ($12\% \times 1/2 \times \$900,000$)		54,000

As a practical expedient, companies are not required to reflect the time value of money to determine the transaction price if the time period for payment is less than a year.

Illustration UP-7 (Revenue Recognition)
Credit Risk Presentation

PRESENTATION OF CREDIT RISK

Facts: Assume that **Best Buy** enters into a contract to sell a new high-definition TV to a customer for \$900. Payment is due in one month after the goods are delivered to the customer. Best Buy expects that the customer will not pay 10% of the consideration based on its knowledge of the customer. The cost of the high-definition TV to Best Buy is \$600.

Question: How should Best Buy record this transaction and how should it be presented on the income statement?

Solution: Best Buy should recognize \$900 in sales revenue, the total contract price. Best Buy would also report an impairment loss on the accounts receivable of \$90 ($10\% \times \900). The journal entry to record the sale transaction and related cost of cost of goods sold is as follows

Accounts Receivable	900	
Sales Revenue		900
Cost of Goods Sold	600	
Inventory		600

The entry to record the impairment loss is as follows.

Bad Debt Expense	90	
Allowance for Doubtful Accounts		90

The presentation on the income statement is as follows.

Sales revenue		
Sales	\$900	
Less: impairment loss	<u>90</u>	
Net sales	810	
Cost of goods sold	<u>600</u>	
Gross profit	<u>\$210</u>	

Allocating the Transaction Price to Distinct Performance Obligations

Distinct performance obligations may include the following.

- (a) Goods produced by companies for sale (for example, inventory of a manufacturer).
- (b) Goods purchased by companies for resale (for example, merchandise of a retailer).
- (c) Providing a service of arranging for another party to transfer goods or services to the customer (for example, acting as an agent of another party).
- (d) Standing ready to provide goods or services (for example, when-and-if-available software products).
- (e) Constructing, manufacturing, or developing an asset on behalf of a customer.
- (f) Granting licenses or rights to use intangible assets.
- (g) Granting options to purchase additional goods or services (when those options provide the customer with a material right).
- (h) Performing a contractually agreed-upon task (or tasks) for a customer.

In some cases, distinct performance obligations are combined. When these distinct performance obligations are combined, the question becomes whether they should be accounted for separately or as one unit. As indicated earlier, they should be combined if the goods or services are highly integrated and if the company significantly modifies the goods or services to fulfill the contract. Illustration UP-8 indicates the factors to consider in allocating the transaction price among performance obligations.⁸

Illustration UP-8 (Revenue Recognition) Allocation – Single Performance Obligation

ALLOCATION OF TRANSACTION PRICE

Facts: Software Technology Inc. licenses customer relationship management software to Lopez Company. In addition, Software Technology promises to provide consulting services to significantly customize the software to Lopez's information technology environment for a total consideration of \$600,000.

Question: How should Software Technology account for this transaction?

Solution: Software Technology is providing a significant service by integrating the good and services (the license and the consulting services) into the combined item for which Lopez has contracted. In addition, the software is significantly customized by Software Technology in accordance with the specifications negotiated with Lopez. Hence, Lopez accounts for the license and consulting services together as one performance obligation. Revenue for that performance obligation would be recognized over time by selecting an appropriate measure of progress toward complete satisfaction of the performance obligation.

In Illustration UP-8, it was determined that an allocation of the transaction price to distinct performance obligations was not needed. If an allocation is needed, the amount allocated to the various performance obligations is based on their relative fair value. The best measure of fair value is what the company could sell the good or service for on a standalone basis. If this information is not available, the seller may use its best estimate of what the good or service might sell for as a standalone unit. A residual value approach might be used if, for example, there is some uncertainty regarding the value of one or more performance obligations. A residual value approach involves estimating the standalone selling price of a good or service by determining the total transaction price and then subtracting from it the value of performance obligations which have a reliable selling price.

Presented on pages UP-29 and UP-30 are two examples of the measurement issues involved in allocating the transaction price.

⁸ The illustrations are adapted from *Proposed Accounting Standards Update (Revised)*, "Revenue from Contracts with Customers" (Norwalk, Conn: FASB, November 14, 2011, and January 4, 2012), page 58.

Illustration UP-9 (Revenue Recognition)
Allocation – Multiple Performance Obligations

ALLOCATION OF TRANSACTION PRICE

Facts: Lonnie Company enters into a contract to build, run, and maintain a highly complex piece of electronic equipment for a period of 5 years, commencing upon delivery of the equipment. There is a fixed fee for each of the build, run, and maintenance deliverables, and any progress payments made are not refundable. In addition, there is a right of return in the arrangement. All the deliverables have a standalone value. There is verifiable evidence of the selling price for the building and maintenance but not for running the equipment. It is determined that the transaction price must be allocated to the three performance obligations: building, running, and maintaining the equipment.

Question: What procedure should Lonnie Company use to allocate the transaction price to the three performance obligations?

Solution: The performance obligations relate to the equipment, maintenance of the equipment, and running the equipment. As indicated, Lonnie can determine standalone values for the equipment and the maintenance agreement. The company then can make a best estimate of the selling price for running the equipment. Lonnie next applies the relative fair value method at the inception of the transaction to determine the proper allocation to each performance obligation. Once the allocation is performed, the company recognizes revenue independently for each performance obligation using regular revenue recognition criteria. In this case, another approach is to use the fair values of the equipment and maintenance agreements and subtract their value from the total transaction price to arrive at a residual value for running the equipment.

Illustration UP-10 (Revenue Recognition)
Allocation – Multiple Performance Obligations

ALLOCATION OF TRANSACTION PRICE

Facts: Handler Company is an experienced manufacturer of equipment used in the construction industry. Handler's products range from small to large individual pieces of automated machinery to complex systems containing numerous components. Unit selling prices range from \$600,000 to \$4,000,000 and are quoted inclusive of installation and training. The installation process does not involve changes to the features of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications. Handler has the following arrangement with Chai Company.

- Chai purchases equipment from Handler for a price of \$2,000,000 and chooses Handler to do the installation. Handler charges the same price for the equipment irrespective of whether it does the installation or not. (Some companies do the installation themselves because they either prefer their own employees to do the work or because of relationships with other customers.) The price of the installation service is estimated to have a fair value of \$20,000.
- The fair value of the training sessions is estimated at \$50,000.
- Chai is obligated to pay Handler the \$2,000,000 upon the delivery and installation of the equipment.

Handler delivers the equipment on September 1, 2012, and completes the installation of the equipment on November 1, 2012. Training related to the equipment starts once the installation is completed and lasts for 1 year. The equipment has a useful life of 10 years. Assume that the equipment, training sessions, and the installation are three distinct performance obligations which should be accounted for separately.

Illustration UP-10 (Revenue Recognition) (cont'd.)

Allocation – Multiple Performance Obligations

Question: How should the fee of \$2,000,000 be allocated to the transaction price?

Solution: The total revenue of \$2,000,000 should be allocated to the three performance obligations based on their relative fair values. In this case, the fair value of the equipment should be considered \$2,000,000, the installation fee is \$20,000, and the training is \$50,000. The total fair value to consider is \$2,070,000 (\$2,000,000 + \$20,000 + \$50,000). The allocation is as follows.

Equipment	\$1,932,367	$(\$2,000,000/\$2,070,000) \times \$2,000,000$
Installation	\$19,324	$(\$20,000/\$2,070,000) \times \$2,000,000$
Training	\$48,309	$(\$50,000/\$2,070,000) \times \$2,000,000$

Handler makes the following entries.

November 1, 2012	
Cash	2,000,000
Service Revenue (installation)	19,324
Unearned Service Revenue	48,309
Sales Revenue	1,932,367

The sale of the equipment should be recognized once the installation is completed on November 1, 2012, and the installation fee also should be recognized because these services have been provided. The training revenues should be allocated on a straight-line basis starting on November 1, 2012, or \$4,026 (\$48,309/12) per month for one year (unless a more appropriate method such as the percentage-of-completion method is warranted). The journal entry to recognize the training revenue for two months in 2012 is as follows.

December 31, 2012	
Unearned Service Revenue	8,052
Service Revenue (training) (\$4,026 × 2)	8,052

Therefore, the total revenue recognized at December 31, 2012, is \$1,959,743 (\$1,932,367 + \$19,324 + \$8,052). Handler makes the following journal entry to recognize the training revenue in 2013, assuming adjusting entries are made at year-end.

December 31, 2013	
Unearned Service Revenue	40,257
Service Revenue (training) (\$48,309 – \$8,052)	40,257

As a practical expedient, if a company has two or more distinct performance obligations, it may bundle these performance obligations if they have the same revenue recognition pattern. That is, they are recognized immediately or they are recognized over time using the same revenue recognition pattern.

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied

A company satisfies its performance obligation when the customer obtains control of the good or service. Indications that the customer has obtained control are:

1. The company has a right to payment for the asset.
2. The company transferred legal title to the asset.
3. The company transferred physical possession of the asset.
4. The customer has the significant risks and rewards of ownership.
5. The customer has accepted the asset.

As indicated in *Intermediate Accounting*, a company recognizes revenue immediately or over time, depending on the circumstances. A company recognizes revenue from a performance obligation over time by measuring the progress toward completion. Companies use various methods to determine the extent of progress toward completion. The most common are the cost-to-cost and units-of-delivery methods. The objective of all these methods is to measure the extent of progress in terms of costs, units, or value added.

Companies identify the various measures (costs incurred, labor hours worked, tons produced, floors completed, etc.) and classify them as input or output measures. Input measures (costs incurred, labor hours worked) are efforts devoted to a contract. Output measures (with units of delivery measured as tons produced, floors of a building completed, miles of a highway completed) track results. Neither is universally applicable to all long-term projects. Their use requires the exercise of judgment and careful tailoring to the circumstances.

Both input and output measures have certain disadvantages. The input measure is based on an established relationship between a unit of input and productivity. If inefficiencies cause the productivity relationship to change, inaccurate measurements result.

Another potential problem is front-end loading, in which significant up-front costs result in higher estimates of completion. To avoid this problem, companies should disregard some early-stage construction costs—for example, costs of uninstalled materials or costs of subcontracts not yet performed—if they do not relate to contract performance.

Similarly, output measures can produce inaccurate results if the units used are not comparable in time, effort, or cost to complete. For example, using floors (stories) completed can be deceiving. Completing the first floor of an eight-story building may require more than one-eighth the total cost because of the substructure and foundation construction.

The most popular input measure used to determine the progress toward completion is the cost-to-cost basis. Under this basis, a company like **Siemens (DEU)** measures the percentage of completion by comparing costs incurred to date with the most recent estimate of the total costs required to complete the contract. The methodology for measuring the percent completion is shown on pages 966-977 in *Intermediate Accounting*.

Other Considerations

A number of other specific situations are discussed both in *Intermediate Accounting* and in the new exposure draft. These situations relate to bill-and-hold, principal-agent, and right-of-return revenue arrangements.

Bill-and-Hold Arrangements. A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future.

Illustration UP-11 (Revenue Recognition) Recognition—Bill-and-Hold

BILL-AND-HOLD ARRANGEMENT

Facts: Butler Company sells \$450,000 of fireplaces to a local coffee shop, Baristo, which is planning to expand its locations around the city. Under the agreement, Baristo asks Butler to retain these fireplaces in its warehouses until the new coffee shops that will house the fireplaces are ready. Title passes to Baristo at the time the agreement is signed.

Question: When should Butler recognize the revenue from this bill-and-hold arrangement?

Solution: When to recognize revenue in a bill-and-hold arrangement depends on the circumstances. Butler determines when it has satisfied its performance obligation to transfer a product by evaluating when Baristo obtains control of that product. For Baristo to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria should be met:

- (a) The reason for the bill-and-hold arrangement must be substantive.
- (b) The product must be identified separately as belonging to Baristo.
- (c) The product currently must be ready for physical transfer to Baristo.
- (d) Butler cannot have the ability to use the product or to direct it to another customer.

In this case, it appears that the above criteria were met, and therefore revenue recognition should be permitted at the time the contract is signed. Butler makes the following entry to record the bill-and-hold sale.

Accounts Receivable	450,000	
Sales Revenue		450,000

If a significant period of time elapses before payment, the accounts receivable is discounted. In addition, if one of the conditions is violated, revenue recognition should be deferred until the goods are delivered to Baristo.

Principal-Agent Relationships. In a principal-agent relationship, amounts collected on behalf of the principal are not revenue of the agent. Instead, revenue for the agent is the amount of the commission it receives (usually a percentage of the total revenue). An example of a principal-agent relationship taken from *Intermediate Accounting* is an airline that sells tickets through a travel agent. For example, assume that Fly-Away Travels sells airplane tickets for **British Airways (BA)** (GBR) to various customers. In this case, the principal is BA and the agent is Fly-Away Travels. BA is acting as a principal because it has exposure to the significant risks and rewards associated with the sale of its services.

Fly-Away is acting as an agent because it does not have exposure to significant risks and rewards related to the tickets. Although Fly-Away collects the full airfare from the client, it then remits this amount to BA less a commission. Fly-Away therefore should not record the full amount of the fare as revenue on its books—to do so overstates its revenue. Its revenue is the commission—not the full fare price. The risks and rewards of ownership are not transferred to Fly-Away because it does not bear any inventory risk as it sells tickets to customers. This distinction is very important for revenue recognition purposes.

Some might argue that there is no harm in letting Fly-Away record revenue for the full price of the ticket and then charging the cost of the ticket against the revenue (often referred to as the gross method of recognizing revenue). Others note that this approach overstates the agent's revenue and is misleading. The revenue received is the commission for providing the travel services, not the full fare price (often referred to as the net approach). The profession believes the net approach is the correct method for recognizing revenue in a principal-agent relationship.

As a result, the new exposure draft includes specific criteria to determine when a principal-agent relationship exists. Indicators that the company is the agent include:

1. The other party has primary responsibility for fulfillment of the contract (that is, the other party is the primary obligor).
2. The company does not have inventory risk.
3. The company does not have latitude in establishing prices.
4. The company does not have customer credit risk.
5. The company's consideration is in the form of a commission.

An important feature in deciding whether Fly-Away is acting as an agent is whether the amount it earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer. The requirements in the exposure draft are essentially current GAAP.

Rights of Return. Sales with rights of return have long been a challenge in the area of revenue recognition. For example, say Hogland Glass Manufacture transfers control of hurricane glass to Henlo Builders. Hogland grants Henlo the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following.

1. A full or partial refund of any consideration paid.
2. A credit that can be applied against amounts owed, or that will be owed, to the entity.
3. Another product in exchange.

To account for the transfer of this glass with a right of return (and for some services that are provided subject to a refund), Hogland should recognize all of the following.

- (a) Revenue for the transferred products in the amount of consideration to which Hogland is reasonably assured to be entitled (considering the products expected to be returned).
- (b) A refund liability.
- (c) An asset (and corresponding adjustment to cost of sales) for its right to recover glass from Henlo on settling the refund liability. An example of a return situation is presented in Illustration UP-12 (on the next page).⁹

⁹ *ibid.*, page 78.

Illustration UP-12 (Revenue Recognition)

Recognition – Right of Return

RIGHT OF RETURN

Facts: Venden Company sells 100 products for \$100 each to Amaya Inc. for cash. Venden allows Amaya to return any unused product within 30 days and receive a full refund. The cost of each product is \$60. To determine the transaction price, Venden decides that the approach that is most predictive of the amount of consideration to which it will be entitled is the most likely amount. Using the most likely amount, Venden estimates that:

1. Three products will be returned.
2. The costs of recovering the products will be immaterial.
3. The returned products are expected to be resold at a profit.

Question: How should Venden record this sale?

Solution: Upon transfer of control of the products, Venden would recognize (a) revenue of \$9,700 ($\100×97 products expected not to be returned), (b) a refund liability for \$300 ($\100 refund \times 3 products expected to be returned), and (c) an asset of \$180 ($\60×3 products) for its right to recover products from customers on settling the refund liability. Hence, the amount recognized in cost of sales for 97 products is \$5,820 ($\60×97).

The journal entries to record this transaction are as follows.

Cash	10,000	
Sales Revenue		9,700
Refund Liability		300
Cost of Goods Sold	5,820	
Asset	180	
Inventory		6,000

If the company is unable to estimate the level of returns with any reliability, it should not report any revenue until the returns become predictive.

Other Issues

In addition to developing the basic revenue recognition model, the exposure draft also addresses the following related issues.

1. Warranties.
2. Onerous contract.
3. Cost of obtaining contract.

Warranties

A warranty is sometimes sold separately from the product. For example as indicated in Chapter 13 (pages 683-684) of *Intermediate Accounting*, when you purchase a television set, you are entitled to a manufacturer's warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost. In this case, the seller should recognize separately the sale of the television with the manufacturer's warranty, and the sale of the extended warranty.

If a customer does not have the option to purchase a warranty separately from the company, then the company should account for the warranty using the expense warranty approach (discussed in Chapter 13, pages 682-683). The textbook treatment is essentially consistent with the treatment of warranties developed in the exposure draft.

Onerous Contract

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it (taken from *IFRS 37*). In other words, a performance obligation is

onerous if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation. In this case, a company should recognize a liability and related expense for the costs that exceed benefits.

To illustrate, assume that Sumart Sports operates profitably in a factory that it has leased and on which it pays monthly rentals. Sumart decides to relocate its operations to another facility. However, the lease on the old facility continues for the next three years. Unfortunately, Sumart cannot cancel the lease nor will it be able to sublet the factory to another party. The expected costs to satisfy this onerous contract are \$200,000. In this case, Sumart makes the following entry.

Loss on Lease Contract	200,000	
Lease Contract Liability		200,000

The expected costs should reflect the least net cost of exiting from the contract, which is the lower of (1) the cost of fulfilling the contract, or (2) the compensation or penalties arising from failure to fulfill the contract.

For example, assume the same facts as above for the Sumart example, and the expected costs to fulfill the contract are \$200,000. However, Sumart can cancel the lease by paying \$175,000. In this case, Sumart should record the liability at \$175,000.

Costs of Obtaining Contract

The exposure draft indicates that a company should recognize an asset for the incremental costs of obtaining a contract that the company expects to recover. These costs should then be amortized on a systematic basis over the life of the good or service to which it relates.

Summary

Revenue is a significant number to users of financial statements in assessing a company's performance and prospects. However, revenue recognition requirements under IFRS differ from those in GAAP, and most believe that both sets of requirements need to be improved. The proposed revenue accounting guidance is intended to improve financial reporting by clarifying the principles for recognizing revenue and creating a converged revenue recognition standard that companies can apply consistently across various industries and capital markets.

Exercises

REVENUE EXERCISE 1 On May 1, 2013, Mount Company enters into a contract to transfer a product to Epic Company on September 30, 2013. It is agreed that Epic will pay the full price of \$25,000 in advance on May 1, 2013. The contract is non-cancelable. Epic, however, does not pay until June 15, 2013, and Mount delivers the product on September 30, 2013. Prepare the entries required for Mount in 2013.

REVENUE EXERCISE 2 Ismail Construction enters into a contract to design and build a hospital. Ismail is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing. Does Ismail have a single performance obligation to the customer in this revenue arrangement? Explain.

REVENUE EXERCISE 3 Crankshaft Company manufactures equipment. Crankshaft's products range from simple automated machinery to complex systems containing numerous components. Unit selling prices range from \$200,000 to \$1,500,000, and are quoted inclusive of installation. The installation process does not involve changes to the features of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications. Crankshaft has the following arrangement with Winkerbean Inc.

- Winkerbean purchases equipment from Crankshaft for a price of \$1,000,000 and contracts with Crankshaft to install the equipment. Crankshaft charges the same price for the equipment irrespective of whether it does the installation or not. The price of the installation service is estimated to have a fair value of \$50,000. The cost of the equipment is \$600,000.
- Winkerbean is obligated to pay Crankshaft the \$1,000,000 upon the delivery and installation of the equipment.

Crankshaft delivers the equipment on June 1, 2012, and completes the installation of the equipment on September 30, 2012. The equipment has a useful life of 10 years. Assume that the equipment and the installation are two distinct performance obligations, which should be accounted for separately. Address the following: (a) How should the transaction price of \$1,000,000 be allocated among the service obligations? (b) Prepare the journal entries for Crankshaft for this revenue arrangement in 2012.

REVENUE EXERCISE 4 Polk Contractors Inc. enters into a contract with a customer to build a customized house. The contract is a single performance obligation given the deliverable promised to the customer. Costs incurred to date in relation to total estimated costs to be incurred are the best measure of the pattern of transfer to the customer. The original transaction price in the contract was \$400,000, with estimated costs of \$240,000. The customer requests changes to the design midway through construction (\$120,000 of costs have been incurred). The modification increases the transaction price and estimated costs by \$120,000 and \$40,000, respectively. How much incremental revenue should be recorded as a result of this contract modification?

REVENUE EXERCISE 5 On June 1, 2012, Mills Company sells \$200,000 of shelving units to a local retailer, ShopBarb, which is planning to expand its stores in the area. Under the agreement, ShopBarb asks Mills to retain the shelving units at its factory until the new stores are ready for installation. Title passes to ShopBarb at the time the agreement is signed. The shelving units are delivered to the stores on September 1, 2012, and ShopBarb pays in full. Prepare the entries for this bill-and-hold arrangement for Mills on June 1 and September 1, 2012. The cost of the shelving units to Mills is \$110,000.

REVENUE EXERCISE 6 Kristin Company sells 300 units of its products for \$20 each to Logan Inc. for cash. Kristin allows Logan to return any unused product within 30 days and receive a full refund. The cost of each product is \$12. To determine the transaction price, Kristin decides that the approach that is most predictive of the amount of consideration to which it will be entitled is the probability-weighted amount. Using the probability-weighted amount, Kristin estimates that (1) 10 products will be returned; (2) the costs of recovering the products will be immaterial; and (3) the returned products are expected to be resold at a profit. Prepare the entry for Kristin at the time of the sale to Logan.

REVENUE EXERCISE 7 On March 1, 2012, Parnevik Company sold goods to Goosen Inc. for \$660,000 in exchange for a 4-year, zero-interest-bearing note in the face amount of \$1,062,937. The goods have an inventory cost on Parnevik's books of \$400,000. Prepare the entries for Parnevik on (a) March 1, 2012, and (b) December 31, 2012.

LEASES

In this section, we summarize the IASB's joint project with the FASB on leases, which is addressed in Chapter 21 (Accounting for Leases).

Background

As discussed in Chapter 21 of *Intermediate Accounting*, leasing is an important source of financing. The existing rules for leases require lessees to classify their leases as either finance leases or operating leases. However, these existing rules are criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In other words, (1) relevant information about rights and obligations that meet the definitions of assets and liabilities are omitted, and (2) existing rules lead to a lack of comparability and undue complexity because of the sharp bright-line distinction between finance leases and operating leases. As a result, many financial statement users adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

In response to these criticisms of lease accounting, the IASB and FASB are working on a joint project to develop a new approach to lease accounting. At the time of this Update, the Boards are planning to issue a revised lease accounting proposal for both lessees and lessors.

Proposed Framework

The general framework adopted by the Boards is that a lease represents the “right-of-use” of an asset. Under this model, a lessee in a lease arrangement recognizes an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term. Lessors recognize a right to receive lease payments and a residual asset at the commencement of the lease.

Lessee Accounting

Under the current proposals, lessees apply a single accounting approach for all leases. This accounting approach requires a lessee to:

- Initially recognize a liability to make lease payments and a right-of-use asset, both measured at the present value of the lease payments.
- Subsequently measure the liability to make lease payments using the effective-interest method.
- Amortize the right-of-use asset on a systematic basis that reflects the pattern of use of the asset.

In essence, the proposed model eliminates (except for short-term leases) the distinction between operating and finance leases. That is, leases are no longer evaluated based on criteria that address whether ownership of the asset has been transferred to the lessee. Rather than accounting for the whole asset, **the proposed model focuses on the part of the asset for which the lease conveys the right of use.** In some cases, this is the whole asset. In other situations, only part of the asset is leased.

Lessor Accounting

For lessors, the Boards propose that a lessor should apply a “receivable and residual” accounting approach as follows.

- The lessor recognizes a right to receive lease payments and a residual asset at the date of the commencement of the lease.
- The lessor initially measures the right to receive lease payments at the sum of the present value of the lease payments, discounted using the rate the lessor charges the lessee.

- The lessor initially measures the residual asset as an allocation of the carrying amount of the underlying asset and would subsequently measure the residual asset by accreting it over the lease term using the rate the lessor charges the lessee.

In situations where the cost of the asset is less than the payments to be received (e.g., a sales-type lease), the lessor accounts for the lease according to whether the profit on the transfer is reasonably assured or not:

- If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor recognizes that profit at the date of the commencement of the lease. The profit is measured as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset.
- If profit on the right-of-use asset transferred to the lessee is not reasonably assured, the lessor defers recognition of the profit. In that case, the lessor initially measures the residual asset as the difference between the carrying amount of the underlying asset and the right to receive lease payments. The lessor subsequently accretes the residual asset, using a constant rate of return. Thus, the profit on the transfer is recognized over the life of the lease.

Illustration of Proposed Model

The following example is used to compare the proposed rules to existing GAAP. Assume that Lessor A owns a two-story building with a fair value of \$2,000,000. The building has a 30-year life with zero residual value. Lessor A plans to lease the building to a tenant on a five-year, non-renewable lease, with annual payments of \$165,000 at the beginning of the year. Lessee B leases the building for the first five-year lease term. Lessee B's incremental borrowing rate is 8 percent.

Analysis—Current IFRS. This lease would most assuredly be classified as an operating lease by the lessee because (1) there is no transfer of ownership, nor is there a bargain-purchase option; (2) the lease term is less than 75 percent of the asset useful life ($5 \div 30 = 16.67\%$); and (3) the present value of the lease payments is less than 90 percent of the fair value of the asset [$\$711,501.45 (\$165,000 \times 4.31213) \div \$2,000,000 = 36\%$]. Thus, under current IFRS, this lease is accounted for as an operating lease (no asset or liability related to the lease is reported on the lessee's balance sheet). The lessee records lease expense for each payment made, and the lessor records lease revenue and continues to report the building on its balance sheet.

Analysis—Proposed Model. Under the proposed lease model, rather than evaluating the lease based on the whole asset, the lessee and lessor analyze the "right of use" asset. That is, the lease conveys to the lessee the right to use the building for five years in exchange for payments of \$165,000 each year. Thus, the lessee makes the following entry at inception of the lease.

Right-of-Use Asset ($\$165,000 \times 4.31213$)	711,501
Lease Liability	711,501

During the lease term, the lessee accounts for the lease liability similar to current finance lease guidance, using effective-interest amortization. The right-of-use asset is accounted for as a limited-life intangible asset (likely with straight-line amortization).

At lease inception, the lessor records a receivable for the payments to be received and derecognizes the portion of the asset transferred to the lessee. Any profit (or loss) arising from the difference between lease receivable and the carrying value of the derecognized portion of the asset is recognized at inception (if reasonably assured). Note that under current IFRS initial gross profit recognized is based on the sale of the entire asset, not just the part of the asset leased. Thus, the new approach results in lower initial profits on leases with these features.

Other Issues

The proposed model abandons criteria designed to assess transfer of ownership of leased assets. However, the model still requires evaluation of some of the same lease characteristics as existing IFRS. Two significant areas of judgment addressed in the proposal relate to (1) the lease term and (2) the discount rate.

Lease Term

The lease term is defined, for both lessees and lessors, as follows.

- The lease term is the non-cancelable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for a company to exercise an option to extend the lease, or for a company not to exercise an option to terminate the lease.
- A lessee and a lessor should reassess the lease term only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease.

Discount Rate

The discount rate to be used by lessees and lessors should be as follows.

- The lessee should use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate.
- The lessor would use the rate the lessor charges the lessee.

The rate the lessor charges the lessee could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used.

The lease term and discount rate provisions are similar to those in existing IFRS. As a result, some of the same difficult subjective judgments will be required to implement the proposed lease accounting model.

Summary

Since 2006, the IASB and FASB have been working to develop improved accounting guidance for leases. The proposed "right-of-use" model shows promise to result in the reporting of more relevant and representationally faithful information about leasing arrangements. As summarized in Illustration UP-1, early analysis of the potential impact of the proposed leasing rules indicates significant effects.

ILLUSTRATION UP-1 (LEASES)

Leasing Statistics and Accounting
Impacts

A quick look at the current leasing market and some possible effects of the proposed rules:

- **\$600 billion.** Annual volume of leased equipment.
- **70%.** Volume of real estate leases as a percentage of all leases held by U.S. public companies.
- **\$1.3 trillion.** Amount of operating lease payments that U.S. public companies will bring back on balance sheets as finance leases under the proposed rule.
- **7%.** Potential first-year average increase in lease expense for a 3-year lease.
- **21%.** Potential first-year average increase in lease expense for a 10-year lease.

Source: Equipment Leasing and Finance Association, 2009; PricewaterhouseCoopers and Rotterdam School of Management, 2009.

As indicated, over \$1 trillion of operating leases will come on-balance-sheet if the rules are adopted. In addition, there will be a significant negative impact on lessee income statements in the early years of leases. As Illustration UP-2 shows, the frontloading of lease expenses will be felt by lessees in several industries.

**ILLUSTRATION UP-2
(LEASES)**

Lease Expense Impacts—By
Industry Sector

<u>Sector</u>	<u>Typical Lease Term (Years)</u>	<u>First-Year % Increase Prompted by % New Rules*</u>	<u>Cumulative % Increase Through Peak Year*</u>
Airline	17	26%	128%/yr. 9
Automotive fleet	3	4	N/A
Banking	10	21	64%/yr. 5
Copier/office equipment	3	7	7%/yr. 3
Industrial-equipment manufacturers	5	11	17%/yr. 2
Health-care equipment	5	11	17%/yr. 2
Information technology	3	7	7%/yr. 2
Rail	22	26	200%/yr. 12
Real estate	10	21	64%/yr. 5
Trucking	7	16	33%/yr. 4

*As compared with the straight-line method of accounting.
Source: Equipment Leasing and Finance Association, 2009.

Given these effects—increased reported debt and lower income—as a consequence of these proposed rules, it is not surprising that the IASB (and FASB) are continuing to receive numerous comments on its proposed lease accounting rules. In response to comments received in 2011 and early 2012, the Boards have affirmed most of the decisions presented in the 2010 exposure draft (e.g., the right-of-use model and elimination of the distinction between finance and operating leases). However, constituents have raised concerns about the complexity of implementing the right-of-use model, as well as the “front-loading” of expense in the subsequent measurement of right-of-use assets for lessees. As a result, the Boards are reconsidering subsequent measurement issues and are seeking additional input. The Boards are expected to issue a new exposure draft on lease accounting in the second half of 2012. Thus, it appears that 2013 will be the earliest that a new leasing standard will be issued.