NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

June 2004

The International Financial Reporting Interpretations Committee met in London on 3 and 4 June 2004, when it discussed:

- SIC-12: Scope exclusion for employee benefit trusts
- IAS 11: Combining and segmenting construction contracts
- IAS 19: Employee benefit plans
- IAS 27: Fiduciaries and control
- IAS 37: Waste electrical and electronic equipment
- IFRIC D3: Draft final Interpretation
- IFRIC D4: Redeliberation
- Service concession arrangements

SIC-12: Scope exclusion for employee benefit trusts

The IFRIC continued its discussions begun at its May meeting. The IFRIC agreed that the scope of SIC-12 *Consolidation—Special Purpose Entities* should be amended as follows:

(a) The scope exclusion for post-employment benefit plans should be amended to clarify its application and also include other long-term employee benefit plans. Specifically, SIC-12 should not apply to post-employment defined benefit plans or other long-term employee benefit plans with plan assets that are required to be included in the measurement of a defined benefit liability or a liability for other long-term employee benefits in accordance with paragraphs 54 and 128, respectively, of IAS 19 *Employee Benefits*.

(b) The scope exclusion for equity compensation plans should be removed.

The IFRIC voted unanimously in favour of publishing a Draft Amendment to SIC-12, proposing the above amendments.

IAS 11: Combining and segmenting construction contracts

The IFRIC considered a summary of the status of its project to develop guidance on combining and segmenting construction contracts.

IAS 11

IAS 11 *Construction Contracts* currently requires segmenting of construction contracts when certain criteria are met, including that each asset has been subject to separate negotiation. In contrast, AICPA Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* permits segmentation when either a primary set of criteria are met or, if those criteria are not met, all of a second set of criteria are met.

The IFRIC confirmed its decision not to incorporate SOP 81-1 paragraph 40 (the primary set of criteria) into the guidance on IAS 11 because they did not think that it strengthened the cause of convergence with US GAAP. It also noted that it needed to examine whether the guidance in SOP 81-1 paragraph 41 represents a different set of criteria for segmenting contracts and, if different, whether this guidance should be incorporated in an Interpretation.

With respect to combining contracts, the IFRIC confirmed that the criteria in SOP 81-1 paragraph 37 addressing the close interrelationship of construction activities and their timing and location should be incorporated into the guidance on IAS 11. The staff will explore whether some obligation to complete further stages of a construction activity is required if the contracts are to be combined.

Some IFRIC members wished there to be a discussion in the Basis for Conclusions of a presumption that different components of the same entity would not constitute a single customer unless there was clear evidence that the components were acting as a single entity. It was noted that in large corporations, different components often have contracting rights; to treat several contracts, negotiated separately by different components of an entity, as one contract would be very difficult in practice.

The IFRIC confirmed that it would include in the draft Interpretation guidance on the effect of options for the construction of an additional asset at the request of the customer or amendments to an existing contract. The IFRIC was of the view that IAS 11 paragraph 10 was sufficient, but agreed to add guidance on the accounting for options that did not meet the criteria in IAS 11 for recognition as a separate construction contract.

Other IAS 11 issues

The IFRIC noted that some issues identified as a result of its consideration of service concession arrangements had implications for IAS 11, and might be of a higher priority than the issues identified originally. The IFRIC noted in particular:

- Clarifying the interaction of IAS 11 and IAS 23 *Borrowing Costs* with respect to the capitalisation of interest
- Whether revenue should be allocated to phases of a project based on different profit margins or on the profit margin for the contract as a whole

(continued)

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Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411

IASB Publications Department, 30 Cannon Street, London EC4M 6XH, United Kingdom.

Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org
Web: www.iasb.org

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IAS 11: Combining and segmenting construction contracts *(continued)*

- Subtle differences between IFRSs and US GAAP with respect to the application of the percentage of completion method, in particular the use of output measures (IAS 11) vs costs incurred (US GAAP) to determine the stage of completion.

Interaction with service concession arrangements

IAS 18 *Revenue* paragraph 21 states that the "requirements of [IAS 11] are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services." The IFRIC is concerned that any guidance on segmenting and combining construction contracts that it might issue on IAS 11 would become the guidance for service revenue recognition, including service revenue arrangements with multiple elements.

In May 2004, the IFRIC extended the project on combining and segmenting construction contracts to allow the use of segmenting based on output measures to be considered further, with a view to developing an Interpretation that would be consistent across both IASs 11 and 18.

IAS 19: Employee benefit plans with promised returns on contributions or notional contributions

The IFRIC considered the outcome of its editorial review of the draft Interpretation. Four matters had arisen in that review:

(a) a need to clarify the way some terminology was being used (especially the use of "promise" and "guarantee");

(b) a need to correct the wording on how the deferred recognition option for actuarial gains and losses under IAS 19 interacts with the proposals (ie on a net rather than gross basis);

(c) a need to clarify how the principles apply when a plan contains a variable component that has a margin attaching to it; and

(d) a need to ensure that the asset ceiling was allowed for in aspects of the implementation guidance and related wording.

In relation to (c), the draft had stated that the variable component of a plan (ie situations in which benefits depend on future asset returns – for example, movements in a share price index) should be measured at the fair value at the balance date of the assets or notional assets upon which the benefits depend. It was agreed that if a margin was promised (for example, above such movements in an index), it should be clarified that the margin should be included in the measure of the plan liability.

The IFRIC will now review the final editorials, provide a marked-up copy for the Board to ensure that no shift in principle has occurred since their review and then move to publication. A 75-day exposure period is to be allowed for comment.

IAS 27: Fiduciaries and control

The staff updated the IFRIC on the Board's discussion of fiduciaries and control its meeting in May 2004. The staff reported that the Board had not made any decisions at that meeting but had agreed in principle that a fiduciary acting solely in that capacity should not satisfy the control definition even if that role enables it to determine another entity's strategic operating and financing policy. The Board had also discussed how the ability to determine strategic operating and financing policy ('power') and control should be assessed when a fund manager has two roles in relation to the same investee—as fund manager with power over a fund with a holding in an investee and as a direct investor (principal). Two approaches were considered. In the first approach, each of the fund manager's interests would be analysed separately to determine whether the fund manager has power and control over the investee. In the second approach, the fund manager's interests in the investee would be analysed together. The Board did not decide which approach should be adopted.

The staff said that the Board would consider these issues at its meeting in June 2004. The IFRIC agreed that after that meeting it would reconsider whether any form of interim consensus addressing the concept of control and fiduciaries would be useful.

IAS 37: Waste electrical and electronic equipment

The IFRIC gave preliminary consideration to an issue raised on the interpretation of an 'obligating event' under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The issue has been raised in conjunction with EU Directives 2002/EC and 2003/108/EC on *Waste Electrical and Electronic Equipment* (WE&EE). The unusual financing features in the Directives define that the cost of waste management for certain equipment will fall to producers of that type of equipment who are in the market when disposal occurs and not necessarily to the actual producers of that equipment. Thus future market share (ie market share at the time disposal occurs) will be the basis to determine the obligation. The critical issue with regard to the application of IAS 37, therefore is whether

(a) putting those type of equipment onto the market is the obligating event and future market share is just a measurement issue, or

(b) whether future market share at the date when the WE&EE costs occur is the obligating event.

The IFRIC tentatively concluded that having market share at the time disposal occurs constitutes the obligating event. The IFRIC asked the Accounting Interpretation Committee of the German Accounting Standards Board (AIC) which raised this issue in the Agenda Committee, to draft an Interpretation on that issue. In particular the IFRIC came to the following decisions:

(a) The scope of the draft Interpretation should be all types of obligations that are dependent upon future market share including (but not limited to) WE&EE costs.

(b) The draft Interpretation should incorporate the WE&EE financing feature concerning historical equipment sold to private households as an example to demonstrate the rationale of the decision.

(c) The IFRIC tentatively agreed to include in the draft Interpretation measurement issues (eg uncertainties in determining the market share) that may arise.

How disposals physically occurring throughout the year and how market share are defined and measured have yet to be determined by EU Member States.

IFRIC D3: *Determining whether an Arrangement contains a Lease*

The IFRIC continued its consideration of comments received in response to the exposure of D3 *Determining whether an Arrangement contains a Lease* that was issued in January. (D3 and comment letters thereon can be found under 'Current Issues' on the IASB's Website.)

The IFRIC noted that in many cases the same assessment of whether an arrangement contains a lease would arise under D3 and US GAAP (ie EITF 01-8 *Determining Whether an Arrangement Contains a Lease*). Nonetheless, the IFRIC observed that different assessments could arise for two principal reasons. First, the effect of the third criterion in D3 ("payments under the arrangement are made for the time that the item is made available for use rather than for actual use of the item") is that the purchaser is always required to assume some pricing risk in an arrangement for there to be a lease. This is not the case under EITF 01-8. Secondly, the second criterion in D3 ("the arrangement conveys a right to use the item …such that the purchaser is able to exclude others from using the item") suggests that a right of use is conveyed in an arrangement for the output from an asset only when the purchaser is taking substantially all of the output from a specific asset. Under EITF 01-8, a right of use is also conveyed if the purchaser controls or operates the underlying specific asset while taking more than a minor amount of the output from an asset.

The IFRIC agreed that given the similarities between IAS 17 *Leases* and SFAS 13 *Accounting for Leases*, there was no compelling reason for different assessments of whether an arrangement contains a lease under IFRSs and US GAAP. Furthermore, the IFRIC noted that that some respondents had expressed concern about the practical difficulties that would arise from different assessments. Therefore, the IFRIC decided that it should seek to eliminate the remaining differences between the models in D3 and EITF 01-8 for determining whether an arrangement contains a lease. The IFRIC concluded that the most effective way of achieving this objective would be to adopt the model from EITF 01-8. The IFRIC noted that a number of respondents also favoured this approach.

The IFRIC agreed that as far as possible it would adopt the actual form of words from EITF 01-8, subject to differences between IAS 17 and SFAS 13. Nonetheless, the IFRIC agreed that it would amend the words of EITF 01-8 if a different form of words would be more usual under IFRSs. For example, it agreed that "more than a minor amount of the output" in EITF 01-8 should be expressed as "more than an insignificant amount of the output" in the final Interpretation, with explanation in the Basis for Conclusions to clarify that, in this context, the IFRIC intends these words to mean the same thing.

In the light of its decision that the model for determining whether an arrangement contains a lease should converge with EITF 01-8, the IFRIC also decided that the requirements relating to reassessing whether an arrangement contains a lease should also converge with US requirements. The IFRIC noted that the changes to the basic model in D3 meant that there was now no compelling conceptual argument for maintaining the different requirements of D3. Therefore, in addition to requiring reassessment if the terms of the arrangement change, the IFRIC decided that an arrangement should also be reassessed if:

- a renewal option is exercised or an extension is agreed to by the parties to the arrangement;
- there is a change in the determination of whether fulfilment is dependent on a specified asset; or
- there is a substantial change to the asset, for example, a substantial physical change to property, plant or equipment.

The IFRIC noted that under the above requirement, lease accounting would apply (or cease to apply) from the time that the arrangement is reassessed (rather than retrospectively applied from the inception of the arrangement). The IFRIC also noted that if an arrangement that contains a lease is required to be reassessed and found still to contain a lease, the lease is reclassified as a finance lease or operating lease only if required by paragraph 13 of IAS 17.

The IFRIC confirmed that the final Interpretation would not address when a component part of an asset is itself an asset for the purposes of applying IAS 17.

The IFRIC agreed that it would reconsider the requirements relating to separating the lease payments from other payments in the arrangement, together with transition and effective date, at a subsequent meeting, following discussions with a number of respondents later in June 2004. The IFRIC noted that its decisions on transition and effective date would be linked, ie it agreed that if it retained the retrospective application requirement of D3, the final Interpretation would not be mandatory for annual periods beginning on or after 1 January 2005.

IFRIC D4: *Interests in Decommissioning, Restoration or Environmental Rehabilitation Funds*

The IFRIC continued its discussions about the accounting for interests in decommissioning, restoration and environmental rehabilitation funds. In response to the concerns raised by constituents about the asset cap that would be imposed by D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*, the IFRIC considered different ways in which it could respond.

The IFRIC tentatively agreed:

- that the model proposed in D4 should be retained as much as possible. The IFRIC noted that most respondents supported the Exposure Draft.
- that the right to reimbursement that is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* may not be the whole of the contributor's interest in the fund, and that the contributor may have an additional right to any surplus in excess of the reimbursement right.
- that this additional right would be a financial asset if the reimbursement was in the form of cash.
- to consider at a future meeting whether it was possible to have a right to a surplus that was not a financial asset.
- to test its model against some real-life examples.
- to consider a draft Interpretation at the next meeting.

The IFRIC considered whether a right to reimbursement in the form of services meets the definition of an intangible asset in IAS 38 *Intangible Assets*. The IFRIC concluded that such a right was an intangible asset, but noted that as IAS 37 dealt more specifically with reimbursement assets, the right was within the scope of IAS 37 and thus outside the scope of IAS 38.

Service concession arrangements

The IFRIC continued its discussion of service concession arrangements, focusing mainly on public-to-private infrastructure concessions, but also aware of the need to consider whether broader application was appropriate.

In May 2004, the IFRIC noted that there seemed to be three possible accounting models being put forward, which could be illustrated with an example. Assume that the concession operator (CO) builds a road at a cost of 100, its construction profit (if recognised) is 10, and total cash inflows over the life of the concession are 200:

- *The physical asset model*: CO recognises the road as its asset, and has no construction revenue. It has 200 of revenue over the life of the concession.
- *The receivable model*: CO recognises construction revenue of 110 and a receivable of 110. The receivable is amortised by 110 of the future cash inflows, and the remaining 90 of the future cash inflows is recognised as revenue over the life of the concession, so total revenue is still 200.
- *The intangible asset model*: In exchange for construction, CO recognises an intangible asset. The IFRIC asked for more work to be done on whether the intangible asset should be measured at 100 or 110, and on whether construction revenue is recognised. The accounting under the intangible asset model is considered more fully below.

Control of the physical asset

In May, the IFRIC considered an analysis of which party should recognise the physical asset as its own, based principally on the risks and rewards approach in IAS 17 *Leases* and IAS 18 *Revenue*. Many IFRIC members were concerned that there was too much emphasis on risks and rewards, and the staff were asked to re-analyse the issues from a control perspective.

The IFRIC discussed a paper which proposed that, in the context of a service concession arrangement, the concession provider (CP) should be considered to control a property owned by CO if CP (including parties related to it) both:

(a) controls or regulates what services CO must provide using the property, to whom it must provide them, and at what price; and

(b) will control, through ownership, beneficial entitlement or otherwise, the residual interest in the property at the end of the concession. This would include cases where CO must replace an existing asset but CP has the residual interest in the replacement.

CP might also control a property owned by CO in other circumstances.

The paper argued that, if both conditions are met, CO in effect manages the property on behalf of CP, who has the ultimate control. As a result, the physical asset would be recognised by CP rather than by CO. In addition, CP would be considered to have the right of use, so there would be no lease of the property. The staff envisaged that the criteria would apply to both new and existing assets, in all cases.

Many IFRIC members liked the simplicity of this proposal, but there was a concern that it might not be consistent with existing GAAP in all cases, particularly those involving existing assets. The IFRIC also discussed whether this was a new model or an application of the existing model in a particular case. The IFRIC had agreed at an earlier meeting that it would not seek to develop a new model for service concession arrangements, but would seek to apply existing GAAP to them. There was also a concern that the approach was different from IFRIC Draft Interpretation D3 *Determining whether an Arrangement contains a Lease*, and that the IFRIC must be able to explain why it is different, and when each approach should apply.

Nevertheless, the IFRIC agreed to use the criteria as a working model for deciding when a newly built asset should be recognised by CP rather than CO, subject to testing them against examples and refining them if necessary.

The IFRIC did not reach a conclusion on whether the criteria should be used as a working model in other cases. However, the staff noted that, where both criteria were met, the application of IAS 18 to transfers of existing infrastructure assets by CP to CO would be likely to give the same result—no sale would be recognised and the assets would continue to be recognised by CP.

Application of the intangible asset model

The IFRIC discussed a paper on the application of the intangible asset model which argued that CO's accounting, in the example described above, should be as follows:

- CO supplies construction services to CP in exchange for an intangible asset.
- This is an exchange of dissimilar items, on which revenue and profit must be recognised under IAS 18. Therefore CO recognises revenue of 110, an intangible of 110, and a construction profit of 10.

- Over the life of the concession, the intangible asset of 110 is amortised against revenues of 200. The net position is the same as in the receivable case, but total revenues are now 310 rather than 200.

Many IFRIC members agreed with the staff analysis, although some were unhappy with the recognition of construction revenue and profit, for various reasons. Some disliked the fact that total revenues would not equal total cash flows, while others noted that this is inevitable when there is a barter transaction. Others felt that it was inappropriate to recognise revenue and profit on what could be seen as a purchasing activity – the acquisition of the intangible asset.

Two members indicated their intention to dissent from any Interpretation that requires total revenue of 310 to be recognised. The staff agreed to consider further whether the intangible asset model absolutely requires construction revenue of 110 to be recognised, or whether (by analogy with the treatment required by IAS 38 for exchanges of intangible assets) it might be possible to restrict revenue to 200 by treating the exchange as one that results in a gain, but no revenue.

The IFRIC also discussed at what point the intangible asset should be recognised. Three possibilities were suggested to them:

- recognise the intangible asset on day 1, together with a liability that is discharged as the construction proceeds;
- recognise a receivable over the period of construction, which is settled by the delivery of the intangible when construction is complete; or
- recognise an intangible asset as construction proceeds.

None favoured recognising the intangible on day 1. The majority took the view that a receivable should be recognised if contract revenue is recognised, but that otherwise the intangible should be built up over the period of construction. Thus, deciding between these two possibilities will depend on the IFRIC's conclusions on revenue under the intangible asset model. If a receivable is recognised, its non-financial nature should be disclosed.

The IFRIC also discussed which contract obligations should be included in the cost of the intangible asset. The IFRIC tentatively agreed that CO should treat obligations to construct new assets, or to enhance either new or existing assets to a condition better than at the start of the concession, as a cost of the intangible. However, all other obligations should be treated as giving rise to operating costs. This includes obligations to maintain, refurbish or replace assets (except for any enhancement element), all of which compensate the owner of the physical asset for the using up of its service potential of the asset over time.

Future plans

The IFRIC agreed that the staff should draft a set of Interpretations for its next meeting at the end of July 2004, supported by papers on any outstanding issues. It is intended that the draft Interpretations will be presented to the July meeting, and debated more fully at the IFRIC's subsequent meeting in early September 2004.

Members' shares in cooperative entities

IFRIC members are currently reviewing a draft Interpretation that incorporates matters raised during its May 2004 meeting. The draft Interpretation is expected to be released for public comment later in the second quarter.

Items not taken to the IFRIC agenda

IAS 12 *Income Taxes*

The IFRIC considered whether two issues related to IAS 12 *Income Taxes* should be added to its agenda:

(a) whether it is appropriate to discount current taxes payable under IFRSs when an agreement with the taxing agency has been reached to permit the entity to pay such taxes over a period greater than twelve months; and

(b) how to classify interest and penalties that arise from unpaid tax obligations.

The IFRIC acknowledged that IFRSs do not specifically address either issue; however, it decided not to add either issue to its agenda at this time. On the first issue, the general view of the IFRIC was that current taxes payable should be discounted when the effects are material. However, it was noted that there is a potential conflict with the requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. As the IASB has tentatively decided to withdraw IAS 20, the members agreed that the issue of discounting current taxes payable should no longer be uncertain and that the topic need not be added to its agenda.

With respect to the classification of interest and penalties, the IFRIC decided that the disclosure requirements of IAS 12 and IAS 1 *Presentation of Financial Statements* provide adequate transparency of these items.

Future meetings and requests for Interpretations

The IFRIC's meetings for 2004 are expected to take place in London, UK, as follows:

29 and 30 July 2004

2 and 3 September 2004

7 and 8 October 2004

4 and 5 November 2004

2 and 3 December 2004

Meeting dates, tentative agendas and additional details about the next meeting will also be posted to the IASB Website at www.iasb.org before the meeting. Interested parties may also submit requests for Interpretations through the IASB Website.

