NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

February 2003

The International Financial Reporting Interpretations Committee met on 4 and 5 February 2003 in London.

Two new members were welcomed: Jeannot Blanchet, Executive Director, Equity Research (Europe), Morgan Stanley, and Ken Wild, Partner, Deloitte & Touche.

Mr. Blanchet and Mr. Wild fill the positions previously filled by Christian Chiarasini and John Smith, respectively.

Agenda items

The IFRIC discussed the following agenda items:

Rights of use

The IFRIC continued its deliberations from the November meeting of its draft Interpretation *Determining whether an Agreement contains a Lease*.

The IFRIC confirmed its view that there are three key elements that need to be present for an arrangement to contain a lease:

(a) the agreement is dependent upon a specific item or items ('the asset');

(b) the entity obtains control over that asset for a specific period of time; and

(c) the entity in effect makes payments under the agreement for its right to use the asset rather than for its actual use.

The IFRIC discussed the second criterion and confirmed its previous decision that an entity that has rights to acquire substantially all of the output produced by a specific asset may obtain control over that asset. However, it agreed that when an entity has rights to acquire output and both:

(a) the price of the output is either fixed per unit of output or indexed to market prices of the output, and

(b) the arrangement requires the seller to pay substantive damages to the entity based on the then current market prices if it fails to deliver,

the entity is paying for output rather than for a right to use, and hence the agreement does not contain a lease. The IFRIC noted that incorporating these additional criteria into the Interpretation would converge with the tentative conclusion of the EITF on the same topic (Issue No. 01-8 *Determining Whether an Arrangement Contains a Lease*) and would also clarify that certain derivative contracts should not fall within the scope of the Interpretation.

For the purposes of convergence, the IFRIC agreed to adopt from the EITF two additional indicators of situations in which an entity might have control over a specific asset:

(a) the entity has the right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling the output or other utility of the asset, and

(b) the entity has the right to control physical access to the underlying asset.

The IFRIC agreed that the assessment of whether an agreement contains a lease should be made at the inception of the agreement based on the facts and circumstances existing at that time.

The IFRIC also agreed to propose that the Interpretation should apply retrospectively and to propose an application date that would result in the Interpretation being applicable in 2005.

The IFRIC instructed the staff to incorporate these points into a revised draft Interpretation for consideration at its next meeting.

Emission rights

Several governments either have, or are in the process of developing, schemes to encourage reduced emissions of pollutants, in particular of greenhouse gases. Some such schemes are based on a 'cap and trade' model whereby participants are allocated emissions rights or 'allowances' equal to a 'cap' (ie target level of emissions) and are permitted to trade those allowances.

The IFRIC continued its discussion from the November meeting and considered a draft Interpretation. It confirmed the decisions made at the November 2002 meeting, namely that:

(a) At the start of a compliance period, an emissions rights scheme gives rise to both (i) an asset (for allowances held); and (ii) a liability, government grant, or income.

(b) The asset for allowances held is an intangible asset that should be accounted for in accordance with IAS 38 *Intangible Assets*.

(c) Under IAS 37 *Provisions Contingent Assets and Contingent Liabilities*, a liability for the obligation to deliver allowances or pay a penalty arises only as the company emits pollutant– there is no such liability at the start of the compliance period when allowances are delivered.

(d) When allowances are awarded for less than fair value (eg free of charge), the difference between the fair value of the allowances and the amount paid for them (if any) is a government grant that should be accounted for in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. Both the allowances and the element of grant should be measured on initial recognition at fair value, resulting in the recognition of deferred income in the balance sheet for the grant.

(continued…)

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On the last point, the IFRIC noted the Board's tentative decision (made at its January 2003 meeting) to withdraw IAS 20 as part of its convergence project. The IFRIC noted that the Board will explore further three possible replacements for IAS 20, namely an approach based on Australian GAAP (UIG-11 *Accounting for Contributions of, or Contributions for the Acquisition of, Non-Current Asset*s), one based on US GAAP (FAS 116 *Accounting for Contributions Received and Contributions Made*) and one based on the existing guidance for government grants contained in IAS 41 *Agriculture.*

The IFRIC discussed how an emission rights scheme would be accounted for under each of these three approaches. In particular, it discussed whether an award of allowances for less than fair value is a conditional government grant that, under the US GAAP and IAS 41 approaches, would result in the recognition of a liability when allowances are first awarded. It also discussed other possible rationales for recognising a liability (rather than income) when allowances are awarded for less than fair value. The IFRIC agreed that the draft Interpretation that is being developed on emission rights should be based on IAS 20, as it is still applicable. However, the possible changes to IAS 20 and their effect should be discussed and respondents asked for their views. The IFRIC also requested that its discussion of this issue be communicated to the Board for it to consider in its work on government grants and revenue.

Finally, the IFRIC discussed whether the draft Interpretation should cover various other issues that the IFRIC has not discussed before and, if so, what guidance it should give. The IFRIC agreed that:

(a) Penalties for failing to deliver allowances equal to actual emissions affect the measurement of the liability that arises under IAS 37 for the obligation to deliver allowances or pay a penalty for actual emissions.

(b) The draft Interpretation should remind companies that an emission rights scheme may result in certain assets becoming impaired in accordance with IAS 36 *Impairment of Assets.*

(c) Under IAS 20, any element of government grant should initially be recognised in the balance sheet as deferred income and subsequently amortised to income over the compliance period to which the grant relates.

(d) The following issues should not be addressed in the draft Interpretation:

    (i) Capital expenditure undertaken to reduce emissions

    (ii) The accounting by brokers that buy and sell allowances

    (iii) Financial incentives for delivering allowances equal to actual emissions

    (iv) 'Green' projects that result in the award of allowances

The IFRIC agreed that schemes for Renewable Energy Certificates should be dealt with in the draft Interpretation to the extent that the issues that arise are the same as those that arise in a cap and trade scheme. However, other issues that arise for Renewable Energy Certificates should not be dealt with.

The IFRIC agreed to continue its discussions and consider a revised draft Interpretation at a future meeting.

IAS 19 *Employee Benefits*: multi-employer plans

IAS 19 gives an exemption from defined benefit accounting for multi-employer plans when sufficient information is not available to use defined benefit accounting. The standard goes on to state that this may occur if:

" (a) the entity does not have access to information about the plan that satisfies the requirements of the standard; or

(b) the plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan."

The IFRIC considered a draft Interpretation giving guidance on when the above criteria would (or would not) be met. The IFRIC agreed to proceed with the Interpretation but wished to strengthen the onus on entities to obtain the necessary information. It was agreed that a revised draft Interpretation would be sent to IFRIC members for their comments.

IAS 19 *Employee Benefits:* Plans that would be defined contribution plans but for the existence of a minimum return guarantee

The IFRIC considered how to account for a plan that would be a defined contribution plan but for the existence of a minimum return guarantee. The terms of the plan are that a contribution is made each year based on the employee's current salary and the employee receives a benefit (a lump sum or an annuity) equal to the contributions paid into the plan plus the return generated on the assets acquired. The employer guarantees a minimum return on the assets over the period to when the benefit is paid.

Two alternative approaches were considered: (i) separating the guarantee from the plan and accounting for a defined contribution plan under IAS 19 and the guarantee under IAS 39 *Financial Instruments: Recognition and Measurement*; and (ii) accounting for the plan using the defined benefit methodology under IAS 19. The IFRIC agreed on the latter approach. It asked the staff to prepare a draft Interpretation that sets out how the defined benefit methodology under IAS 19 would be applied to this kind of plan, for consideration at a future meeting.

Changes in Decommissioning and Similar Liabilities

Many entities have obligations to dismantle and remove an asset and/or restore its site ('decommissioning and similar liabilities'). IAS 37 contains requirements on how to measure decommissioning and similar liabilities. However, it does not provide guidance on how to account for *changes* in those liabilities.

The IFRIC reviewed a draft Interpretation on how to account for changes in the measurement of decommissioning and similar liabilities. The IFRIC tentatively agreed the following:

(a) Changes in a decommissioning or similar liability that result from a change in the current best estimate of cash flows required to settle the obligation or a change in the discount rate, shall be:

    (i) added to (or deducted from) the amount recognised as the related asset to the extent the change relates to future periods. However, to the extent that such a treatment would result in a negative asset, the effect of the change should be recognised in the current period; and

(ii) reported as income or expense to the extent the change relates to the current or prior periods.

(b) Accordingly, once the related asset has reached the end of its useful life, any changes in the liability that result from a change in the current best estimate of cash flows required to settle the obligation or a change in the discount rate, shall be reported as income or expense.

(c) The unwinding of the discount shall be recognised in profit or loss in the period it occurs. It is not a borrowing cost for the purposes of IAS 23 *Borrowing Costs*.

In addition to considering the draft Interpretation, the IFRIC also discussed the following:

How to calculate the amount to be added to (or deducted from) the asset

The IFRIC agreed that it would not prescribe a method for calculating the amounts that should be allocated to prior, current and future periods. However, the draft Interpretation should contain principles for determining a suitable allocation method and give illustrative examples of methods that might be used.

Transition

The IFRIC tentatively agreed that for existing IFRS preparers, prospective application would be permitted with retrospective application encouraged.

The IFRIC agreed that it would consider at a later date whether this transition method was also appropriate for entities adopting IFRSs for the first time.

The Reporting Financial Performance project

The draft Interpretation does not contain guidance on presenting the effect of changes in decommissioning liabilities in the income statement. The IFRIC agreed that it would not provide such guidance, because any guidance would be superseded by the Board's work in its project on Reporting Financial Performance.

Disclosure

The IFRIC agreed that disclosure guidance is not needed in the draft Interpretation because IAS 1 *Presentation of Financial Statements,* IAS 16 *Property, Plant and Equipment* and IAS 37 already contain sufficient disclosure guidance.

Decommissioning funds

The IFRIC continued its discussion from the November 2002 meeting on decommissioning and environmental rehabilitation funds and considered a draft Interpretation.

The IFRIC confirmed its preliminary view from the November meeting that IAS 19 should not be applied, in whole or in part to decommissioning funds.

The IFRIC agreed that the section on control, joint control, and significant influence in the draft Interpretation should be limited. Rather, the draft Interpretation should concentrate on accounting for the asset of the right to the receive reimbursement from the fund.

The IFRIC discussed the accounting for the asset of the right to the receive reimbursement from the fund, and in particular whether this asset falls within the scope of IAS 37 or IAS 39

The IFRIC agreed that when the asset meets the definition of a financial asset in IAS 39, it should be accounted for under IAS 39 because the scope of IAS 37 excludes those items which are the subject of another Standard. It also agreed that such an asset would seem to fall to be classified as an originated loan under IAS 39 and, depending on what assets the fund invests in, may also contain an embedded derivative. The IFRIC noted that this did not seem appropriate since the asset has no stated maturity date and no specified interest rate. A better treatment would seem to be to account for the whole asset at fair value with changes in fair value reported in the income statement. The IFRIC noted that this would be achieved under IAS 39 if the entity is unable to measure the embedded derivative reliably, since in such a case IAS 39 paragraph 26 requires that the entire combined contract is treated as a financial instrument held for trading.

The IFRIC instructed the staff to prepare a paper for the Board setting out its concerns about classifying this kind of asset as an originated loan, and explore the possibility of invoking IAS 39 paragraph 26 to account for the asset at fair value. In addition, the IFRIC directed the staff to raise with the Board the issue that since a right to reimbursements meets the definition of a financial asset, it is not clear to which circumstances other than insurance contracts issued by non-insurance entities (that are outside of the scope of IAS 39) IAS 37 paragraphs 53 and 54 are intended to apply to.

Linkage

The IFRIC continued its discussions from the July 2002 meeting of 'linkage', namely where the accounting treatment of two or more transactions differs depending on whether those transactions are accounted for together or separately. It noted that the Board in its October 2002 meeting had supported the IFRIC's work on linkage and requested that the IFRIC continue to develop guidance, with a view to it being incorporated into IFRS as either an amendment to a Standard, an amendment to the *Framework* or an IFRIC Interpretation.

The IFRIC agreed proposed indicators for when transactions should be linked and proposed guidance on accounting for linked transactions, subject to certain minor changes. It also agreed that the guidance is the application of the *Framework*'s principles of relevance, reliability, faithful representation, and substance over form.

The IFRIC also tentatively agreed the following:

(a) The guidance should not address situations when a single transaction should be divided into two or more components. However, the introduction should note that in some cases reporting the substance of a single transaction requires that it is divided into two or more components.

(b) The guidance should include two high-level disclosure requirements.

(c) The guidance should be given the title 'Reporting Linked Transactions'.

(d) The guidance should contain indicators rather than conditions for when transactions should be linked, since this is more in keeping with the Board's desire to develop principles-based Standards.

(e) The IFRIC should propose to the Board to consider issuing the guidance for the time being in the form of an Interpretation, unless it wished to issue a Standard.

Liaison update

The IFRIC discussed new projects being undertaken by interpretive committees of national standard-setters, and whether any of these projects might form suitable agenda items for the IFRIC. The IFRIC did not identify any new agenda items among these projects.

Items not taken on the agenda

Listed below are decisions of IFRIC not requiring publication of an Interpretation. A comprehensive list of all the items for which the IFRIC has agreed not to require publication of an Interpretation can be found on the IASB's Website.

IAS 15 and IAS 29 – Hyperinflationary Economies

The issue is that if an entity is in an economy that is determined to have become hyperinflationary, whether and how amounts for the prior year should be restated. The IFRIC agreed that the comparative financial statements must be restated. However, some disagreed with the proposed reasoning for this conclusion, namely that beginning to apply IAS 29 *Financial Reporting in Hyperinflationary Economies* is a change in accounting policy.

The IFRIC asked the staff to reconsider the proposed reasoning with the Agenda Committee at its next meeting.

IAS 36 – The inclusion/exclusion from value in use of cash flows expected to arise from a future restructuring

The issue focused on IAS 36 paragraph 37, which requires the cash flows used in the value in use calculation not to include cash flows that are expected to arise from (a) a future restructuring to which an enterprise is not yet committed; or (b) future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made.

The IFRIC noted that it was likely that resolution of these issues would require an amendment to IAS 36. Also the IASB is already amending IAS 36 as part of its project on business combinations. For these reasons, the IFRIC agreed that these issues would be better addressed directly by the Board rather than by the IFRIC.

Deferred tax omnibus

The issue is whether the IFRIC should add six deferred tax issues to its agenda. Three of the issues concern whether, and how, entities should apply the exemption from recognising deferred tax on initially recognising assets and liabilities; two concern the recognition of deferred tax in connection with equity instruments; and one is a specific application issue.

The IFRIC noted that all of the issues would potentially be affected by the Board's short-term convergence project on IAS 12 *Income Taxes* that will be discussed by the Board in March. The IFRIC agreed to await the Board's decision on the scope of that project before deciding whether to proceed with these agenda items.

Presentation – Operating and Ordinary Activities

The Board, in its Exposure Draft of Improvements to IAS 1, is proposing to delete the requirement that the line items: "the results of operating activities" and "profit or loss from ordinary activities" be presented. Nevertheless, some entities are likely to continue presenting these line items, either voluntarily or because they are required to (eg by local law).

The IFRIC discussed whether it would be appropriate for it to give guidance on the types of items that *would not* be included in operating activities and ordinary activities. The IFRIC agreed not to take this item on its agenda because it would be best dealt with by the Board in its project on Reporting Financial Performance.

Future meetings and requests for Interpretations

The IFRIC's meeting dates from April to December 2003 are expected to take place in London, UK, and are as follows:

1 and 2 April

1 and 2 July

30 and 31 July

30 September and 1 October

2 and 3 December

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