IASB

NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IFRIC UPDATE

February 2005

The International Financial Reporting Interpretations Committee met in London on 3 and 4 February 2005, when the principal matters it discussed were:

- Service concession arrangements
- IFRS 2 – Treasury share transactions and group transactions
- IFRS 2 – Scope
- Emission Rights – consideration of possible approaches for revision of IAS 38
- Applying the restatement approach under IAS 29 *Financial Reporting in Hyperinflationary Economies*
- IAS 11 – Combining and segmenting contracts
- Reassessment of embedded derivatives

The IFRIC finalised five publications at this meeting. Including these, the IFRIC has approved the following 12 documents since November 2004:

Published

- IFRIC *Amendment to SIC-12 Consolidation – Special Purpose Entities*
- IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*
- IFRIC 3 *Emission Rights*
- IFRIC 4 *Determining whether an Arrangement contains a Lease*
- IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*
- IFRIC D10 *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*
- IFRIC D11 *Changes in Contributions to Employee Share Purchase Plans*

Finalised (to be published shortly)

- IFRIC 6 *Applying the restatement approach under IAS 29 Financial Reporting in Hyperinflationary Economies.*
- IFRIC D12 *Service Concession Arrangements – Determining the Accounting Model*
- IFRIC D13 *Service Concession Arrangements – The Financial Asset Model*
- IFRIC D14 *Service Concession Arrangements – The Intangible Asset Model*
- IFRIC D15 *Reassessment of Embedded Derivatives*

Service concessions

[Agenda Item 2]

Illustrative examples

The IFRIC considered examples illustrating the effects of applying the proposed models for accounting for service concession arrangements.

The IFRIC agreed that the draft Interpretation should include an example of the intangible asset model that assumed that the intangible asset was received only once the construction of the infrastructure was complete and should highlight that although the draft interpretation illustrated this particular fact pattern, it did not specify when the intangible asset should be recognised, and that two other approaches might also be appropriate.

The first alternative would be to recognise an intangible asset from the outset (with a corresponding liability in respect of outstanding obligations).

The second alternative would be to build up the intangible asset as construction progressed.

The IFRIC decided to invite constituents to comment on whether the timing of recognition should instead be specified in the interpretation and, if so, which of the proposed approaches should be specified.

The IFRIC discussed a staff proposal that the accounting requirements for the operator's repair and renewal obligations should be different between the financial and intangible asset models. Although IFRIC members expressed concerns that identical obligations should be accounted for differently, the majority accepted the conclusion that the different requirements were consistent with IFRSs and a consequence of the difference between being party to a financial contract and holding an intangible asset.

The IFRIC agreed to include in the Invitation to Comment a question about whether it had interpreted existing IFRSs correctly in reaching this conclusion.

The staff reported that members of a Spanish working group on service concessions had raised concerns that, by choosing an artificially short construction period and assuming that toll revenues would not increase over the duration of the contract, the examples understated the extent to which operators applying the intangible asset model could report losses in early years and correspondingly higher profits in later years. They had suggested choosing a longer period, such as 50 years.

The IFRIC agreed that it would be useful for respondents with a particular interest in the impact of the models in practice, as opposed to the accounting treatments covered by the existing examples, to have access to a more expansive example, ie one with a longer concession period and more intricate fact pattern. While service concession operators would have access to examples of their own, other constituents would not. In addition, it would be helpful if all respondents were referring to the same example when commenting on the practical consequences. The IFRIC agreed to post a more comprehensive example on its Website during the comment period for the draft Interpretations. The draft Interpretation would alert constituents to the presence of the comprehensive example.

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London EC4M 6XH, United Kingdom.

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 7332 2730
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org
Web: www.iasb.org

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Service Concessions *(Continued)*

Subject to some minor changes, the IFRIC approved the illustrative examples for publication with the draft interpretations.

Other aspects of the proposals

The IFRIC agreed that:

- a paragraph should be added to D13 (i) to explain how the IFRIC had reached its interpretation that IAS 11 *Construction Contracts* allowed recognition of different profit margins on different elements of a non-segmented contract and (ii) to note that the IFRIC intended to address this matter more explicitly in a separate interpretation.
- a paragraph should be added to the Basis for Conclusions on D12 to explain how the IFRIC had reached its conclusion that whether the grantor had the primary responsibility to pay the operator for its services should be determined by reference to the substance of the arrangements. The Invitation to Comment would include a question on this proposal.
- the wording of the transitional arrangements in D13 and D14 should be improved to make it clearer that they did not permit continued recognition of infrastructure and obligations that did not meet the recognition requirements of IFRSs.

Exposure period

The IFRIC decided that the comment period should be lengthened beyond the usual 60 days only to the extent that it would remain possible for the staff to prepare an analysis of the comments in time for discussion at the IFRIC's meeting on 2 and 3 June.

Letter from European Commission

The Chairman reported that the IASB had received a letter from the European Commission. The letter set out the Commission's concerns that the service concessions interpretations were unlikely to be finalised until late in 2005 and would not come into effect until financial years beginning on or after 1 January 2006. Concession operators would have to first apply IFRSs in 2005 without the interpretations being in place. They would then have to change their accounting policies again in 2006 – the second change in two years.

The Commission noted that the European Financial Reporting Advisory Group had taken the view that the best way of avoiding this outcome would be to allow companies to continue to apply their current accounting policies in 2005. EFRAG had suggested that this solution could be achieved by giving a temporary relief from the requirements of IAS 8, similar to the relief that the Board had granted for insurance contracts in IFRS 4 and exploration and evaluation expenditure in IFRS 6.

The staff explained to the IFRIC that the rationale that had underpinned the reliefs in IFRS 4 and IFRS 6 was not applicable to service concession arrangements. Insurance contracts and exploration and evaluation expenditure were explicitly excluded from the scope of the IFRSs that would otherwise have been relevant. There was great uncertainty over what the requirements should be and the Board had accepted that it should not require changes in practice that might well be reversed when a comprehensive accounting standard was completed. It was thus necessary to exempt reporting entities from paragraphs 11 and 12 of IAS 8. (These paragraphs, which applied to transactions for which there was no specific accounting standard or interpretation, required entities to develop accounting policies by reference to the requirements for similar transactions, the *Framework* and other accounting literature.)

In contrast, service concession arrangements were *not excluded* from the scope of relevant standards such as IASs 11, 16, 18, 23 and 37. Thus paragraphs 10 - 12 of IAS 8 did not apply and giving temporary relief from them would serve no practical purpose. The service concession operators would be able to continue their present practices only if they were granted an exemption from applying other standards and interpretations in 2005. It was not the place of either the IFRIC or the Board to grant such an exemption. There was no suggestion that existing standards were inappropriate for service concession arrangements; the draft interpretations were seeking to clarify, not amend, existing requirements.

Board Members had expressed the view that the selection of an effective date and the form of transitional provisions were the ways to handle change brought about by interpretations. The concessions proposals already made use of such mechanisms.

The IFRIC agreed with this analysis and agreed that the Invitation for Comment should include a question on the proposed effective date.

IFRS 2 – Treasury share transactions and group transactions

[Agenda Item 3]

The IFRIC considered a preliminary draft Interpretation of share-based payment arrangements in which:

- an entity grants options to its employees and chooses to or is required to purchase its own shares upon exercise of the options by its employees
- a subsidiary's employees are granted rights to shares of the parent.

In the latter situation, questions arise about the application of paragraph 3 of IFRS 2 *Shared-based Payment* in the individual or separate financial statements of the subsidiary and its parent.

The IFRIC agreed that the draft should be amended as necessary to reflect the following tentative decisions on the classification of share-based payment arrangements as equity-settled or cash-settled:

(a) Share-based payment transactions in which an entity grants to its employees rights to its own equity instruments should be accounted for as equity-settled transactions. This applies irrespective of whether the entity chooses or is required first to buy those equity instruments from another party, for subsequent transfer to its employees under the share-based payment arrangement.

(b) If a parent entity grants rights to its equity instruments directly to the employees of a subsidiary entity under a group share-based payment arrangement, the subsidiary should account for the transaction in which it receives services from its employees as an equity-settled transaction.

(c) In the situation described in (b), an employee might transfer employment from one subsidiary to another during the vesting period, without the transfer affecting the employee's rights under the group share-based payment arrangement. The subsidiary entity with which the employee commences employment should recognise the services received from the employee on the basis of the fair value of the equity instruments at the date those equity instruments were originally granted to the employee by the parent entity.

(d) If a subsidiary entity grants to its employees rights to equity instruments of the parent entity, the subsidiary entity should account for the transaction as a cash-settled transaction. This applies irrespective of whether the parent entity and the subsidiary entity enter into a separate agreement whereby the parent entity agrees to provide the equity instruments needed for the subsidiary entity to satisfy its obligations to its employees.

In the situation described in paragraph (d) above, the IFRIC also discussed how the parent entity and subsidiary entity should account, in their separate or individual financial statements, for the separate agreement between the parent entity and its subsidiary. IFRIC members requested the staff to provide an analysis of this issue for discussion at its next meeting.

Scope of IFRS 2

[Agenda Item 4]

The IFRIC continued its discussion of a preliminary draft Interpretation on the scope of IFRS 2. At its meeting in November 2004, the IFRIC tentatively agreed to develop a draft interpretation to address the issue of whether it is necessary to demonstrate that the entity has received goods and services for an issue of equity instruments to be within the scope of IFRS 2. In particular, the issue is whether, or in which circumstances, IFRS 2 applies to transactions in which an entity has granted equity instruments and the fair value of the identifiable assets received (including cash) appears to be less than the fair value of the equity instruments granted.

The IFRIC requested the staff to amend that draft by focusing more clearly on the IFRIC's tentative conclusion that the scope of IFRS 2 is not limited to transactions in which the entity is able to demonstrate that it has received (or expects to receive) goods or services. The IFRIC will discuss a revised draft at its next meeting.

Emission rights – Consideration of possible approaches for revision of IAS 38

[Agenda Item 5]

The IFRIC considered possible approaches for alleviating the effects of mixed measurement bases when accounting for an emission rights scheme in accordance with IFRIC 3 *Emission Rights*. Such circumstances arise when allowances are measured either at (i) cost or (ii) fair value with changes in value above cost recognised in equity, whereas the emissions liability is measured in accordance with IAS 37, normally by reference to the market value of the number of allowances required to settle the obligation, with changes in value recognised in profit or loss.

The IFRIC directed the staff to develop an amendment to IAS 38 for consideration at its next meeting. The objective of this amendment would be to facilitate currency-like intangible assets (eg emission allowances that can be used to settle emission liabilities) to be measured at fair value, with all changes in value recognised in profit or loss rather than equity. The amendment would result in a consistent basis of measurement for the assets and liabilities in an emission rights scheme and consistent presentation of the changes in the value of those assets and liabilities.

The IFRIC was also informed of a suggestion by the Chair of the EFRAG that emission allowances should be able to be designated as a hedge of forecast emissions. The suggestion extends the IFRIC's observation that an emission allowance is similar to currency and therefore seeks to apply, by analogy, the hedge accounting provisions in IAS 39 *Financial Instruments: Recognition and Measurement*. The IFRIC noted that the suggestion would, as a minimum, require an amendment of IAS 39 to permit a non-financial asset to be designated as a hedging instrument. It will consider the suggestion further at its next meeting.

The staff was also asked by the IFRIC, as a separate matter, to consider the appropriate recognition point and amortisation period for the grant of allowances, when the number of allowances that an entity will receive is agreed with the government before the start of, say, a three-year period, but the allowances themselves are issued in three instalments towards the start of each year.

Applying the restatement approach under IAS 29 *Financial Reporting in Hyperinflationary Economies*

[Agenda Item 6]

The IFRIC continued its deliberations of comments received in response to the exposure of D5 *Applying IAS 29* Financial Reporting in Hyperinflationary Economies *for the First Time*, issued in March 2004. (D5 and the comment letters received can be found on the IASB's Website, www.iasb.org).

At the July 2004 meeting, the IFRIC observed that several respondents disagreed or expressed concerns with the restatement approach in D5 (and IAS 29). Many of those respondents did not believe that restating financial information provides useful information; others cited costs versus benefits as their primary objection. As an alternative to the restatement approach some respondents proposed that D5 should permit entities either to restate the financial statements or to apply a 'stable/hard currency approach' (the latter as under US GAAP in accounting for subsidiaries in a hyperinflationary environment). Others suggested that D5 should be amended to require an entity to restate its financial statements for the effect of inflation from the beginning of the year the entity identifies the existence of hyperinflation and not, as clarified, from the date of acquisition of its non-monetary assets.

At this meeting, the IFRIC observed that the IASB has invited the Argentine and Mexican standard-setters to explore in a preliminary research project the accounting for hyperinflation. The IFRIC noted that an amendment of IAS 29 might be considered as only a limited technical change of the standard but it would be a fundamental change in the methodology of the accounting for hyperinflation. Lastly, IFRIC members observed that the IASB had considered the costs vs benefits argument regarding the restatement approach when it developed guidance for first-time adopters in IFRS 1. Accordingly, the IFRIC agreed not to amend IAS 29 in this project but to pass the respondents' concerns to the Board for it to consider when it decides whether to take a project on hyperinflation accounting on to its agenda.

Based on its previous decisions, the IFRIC tentatively approved the following amendments to D5, subject to additional clarification and editorial changes:

- clarification that the interpretation applies to interim financial statements as well as annual financial statements.
- deletion of paragraph 6 of D5 because that paragraph merely emphasises the exemption from the restatement approach in IAS 29, rather than interprets the standard.
- limiting the example to illustrate the restatement of deferred tax items only, and clarifying that part of the restatement of deferred tax items is a monetary gain or loss which should be presented together with the gain or loss on net monetary position.
- clarification that although deferred tax items meet the definition of monetary items in the restated financial statements they are measured as if an entity had always applied IAS 29.

IFRIC members observed that D5, as drafted, is concerned only with applying IAS 29 for the *first time*. The IFRIC decided to clarify that the Interpretation should apply whenever an entity begins the restatement approach under IAS 29 and, as a consequence, changed the title to 'Applying the Restatement Approach under IAS 29 *Financial Reporting in Hyperinflationary Economies*'.

IAS 11 Construction Contracts – Combining and segmenting contracts

[Agenda Item 7]

In May 2003, the Board asked the IFRIC to consider the guidance for combining and segmenting contracts in US AICPA Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* with a view to:

- adding guidance in IAS 11 on the criteria for combining and segmenting contracts.
- clarifying that the conditions in IAS 11 for combining contracts are such that it will be rare for a group of contracts with more than one customer to meet those conditions.
- considering whether the additional criteria for segmenting contracts in US GAAP are consistent with the requirements in IAS 11.

At its June 2003 meeting, the IFRIC Agenda Committee supported the Board's request to add this item to the IFRIC's agenda. In addition, the staff were asked to consider the requirements in IAS 11 and SOP 81-1 for contracts that have additional assets constructed, and the impact they have on combining and/or segmenting.

In September 2003 and March 2004, the IFRIC considered a draft interpretation that would provide additional guidance on when it would be appropriate to combine or segment construction contracts and the effect of options that provide for the construction of an additional asset. The staff had proposed to do this by importing additional guidance based on SOP 81-1. However, some of the IFRIC members raised concerns and asked the staff to reconsider the guidance.

At the February 2005 meeting, the IFRIC considered the March 2004 draft interpretation and a comparative analysis of the conditions for combining and segmenting construction contracts under IFRSs and US GAAP. It then considered whether it wished to continue with its work on this topic. It noted that, since first considering this matter, it had, through its discussions on service concessions, developed its understanding of the operation of the provisions of IAS 11 for gross recognition of revenue and costs (the 'gross approach'), as opposed to recognition of a percentage of expected contract profit under US GAAP. This had clarified that whether contracts were combined or segmented was perhaps of less importance than it had previously thought. The draft interpretations on service concessions would explain that, by measuring revenue and costs in a gross manner, different margins could be recognised on different elements of a contract, whether or not these elements were combined or segmented.

The IFRIC tentatively agreed not to proceed with the March 2004 draft Interpretation. It tentatively concluded that developing guidance on combining and segmenting construction contracts was not a priority for the IFRIC at this time. IFRIC members were concerned that such an interpretation would have a limited effect on financial reporting because:

- the conditions for combining and segmenting under IFRS and US GAAP were not inconsistent (although US GAAP was elective whereas under IAS 11 contracts must be combined or segmented when certain conditions are met), and an IAS preparer with a US listing should be able to get to the same answer under both reporting frameworks; and
- the IFRIC members were not aware of any significant divergence in practice.

The IFRIC is also considering the possible interrelationship of the conditions for combining and segmenting construction contracts under IAS 11, on accounting for service and multiple element arrangements. IAS 18 *Revenue* paragraph 13 states that the 'recognition criteria of this standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.' IAS 18 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 noted that SOP 81-1 applied to construction contracts whilst

EITF 00-21 *Revenue Arrangements with Multiple Deliverables* applied to other contracts.

The IFRIC tentatively concluded that this aspect of the project might well lead to an important interpretation on IAS 11 and possible recommendations for amendments to existing standards.

The IFRIC agreed to communicate its tentative conclusions and analysis to the IASB before proceeding. The staff agreed to prepare a report for consideration at the March IFRIC meeting.

Reassessment of embedded derivatives

[Agenda Item 8]

The IFRIC reaffirmed its decision made in December 2004 on reassessment of embedded derivatives. It agreed that:

- an entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative instrument when the entity first becomes party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract, in which case it is required.
- first-time adopters should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative instrument based on the conditions that existed when it first became a party to the contract rather than those at the date of adoption of the IFRS.

The IFRIC tentatively agreed to publish a draft interpretation reflecting these decisions.

The IFRIC also considered other issues arising from its conclusions, in particular

- whether the draft Interpretation would create a difference with US GAAP. The IFRIC noted that its decision could create such a difference, though some would dispute this. However, it also noted that any difference would arise not only from the requirement about whether reassessment is required but also from the existing differences in the definition of a derivative.
- whether a requirement that reassessment of whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative instrument is prohibited could be extended to the assessment of contracts for non-financial assets that fail to be treated as a derivative because they are in accordance with an entity's expected purchase, sale and usage requirements. The IFRIC noted that its decision relates only to the issue of reassessment of whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative instrument and not to whether a stand-alone contract is within the scope of IAS 39. Accordingly, the IFRIC decided to clarify this in the Basis for Conclusions to the draft interpretation.
- if a group acquires an entity that has entered into contracts containing embedded derivatives, the question arises whether the group assesses whether those embedded derivatives need to be separated from the host contracts and accounted for as derivative instruments on the basis of conditions at the date of acquisition, this being when the group first becomes a party to the contracts, or when the entity being acquired first became a party to the contracts. The IFRIC noted that this issue raises wider questions of reclassification on the acquisition of another entity that go beyond the scope of this draft interpretation. However, given the importance of this wider issue, it decided to consider addressing it in a separate interpretation of IFRS 3.

Items not added to the Agenda

The IFRIC discussed a potential agenda item regarding the accounting for the acquisition by the reporting entity of a third party interest in a subsidiary. The IFRIC recognised that this is an urgent issue and that there is wide divergence in current practice, but that this issue is to be addressed in the Board's Phase 2 project on Business Combinations. The IFRIC concluded that it would monitor the progress of the Board's project, and reconsider whether to add the issue to the agenda later in 2005. No further decisions were made at this meeting regarding issues to be added to the agenda.

Future meetings and requests for Interpretations

The IFRIC's meetings for 2005 are expected to take place in London, UK, as follows:

- 31 March and 1 April 2005
- 2 and 3 June 2005
- 28 and 29 July 2005
- 1 and 2 September 2005
- 3 and 4 November 2005
- 1 and 2 December 2005

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.