NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB

IFRIC UPDATE

November 2002

The International Financial Reporting Interpretations Committee met on 25 and 26 November 2002 in London.

The IFRIC had a very productive meeting, with decisions being arrived at on six issues, on each of which a consensus will now be drafted. Additionally, the IFRIC will be providing short-term reports to the Board on three further matters.

Agenda items

The IFRIC discussed the following agenda items:

Rights of use

The IFRIC continued its discussion from the August meeting of when a right of use constitutes a lease. It considered a revised draft Interpretation on determining whether an arrangement contains a lease. The purpose of this draft Interpretation is to help entities to identify when they have entered into an arrangement that contains a lease falling within the scope of IAS 17 *Leases*.

The IFRIC agreed that there are three elements that need to be present for an arrangement to contain a lease:

1. an asset is implicitly or explicitly specified by the arrangement;
2. the purchasing entity obtains control of the asset, for example by being able to exclude others from using the asset for the duration of the arrangement; and
3. the purchasing entity makes payments for its right to use the asset rather than for actual use of the asset.

The IFRIC considered arrangements in which entities acquire substantially all of the output produced by an asset (for example, under a take-or-pay power contract) and concluded that such arrangements can contain a lease (either operating or finance, depending for example on the length of the arrangement in relation to the useful life of the underlying asset). The IFRIC noted that such arrangements may contain both a lease of an asset and a contract for related services (eg for the operation of the asset). It therefore agreed to consider giving guidance on how to distinguish the minimum lease payments from payments for related services.

The IFRIC instructed the staff to prepare a pre-ballot draft of a revised draft Interpretation for consideration before 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 emission rights or ‘allowances’ equal to a ‘cap’ (ie target level of emissions) and are permitted to trade those allowances. Participants are allocated a year’s worth of allowances at the start of each compliance period, free of charge. At the end of the period, participants are required to deliver allowances equal to actual emissions for the period—failure to deliver sufficient allowances results in a penalty. However, participants are *not* required to reduce emissions to the cap.

The IFRIC continued its previous discussion from the July meeting. In particular, it considered the following three issues:

1. Whether at the start of a compliance period, such an emission rights scheme gives rise to (a) a net asset or liability (for the excess allowances over, or shortfall below, those expected to be required in respect of actual emissions) or (b) a separate asset (for allowances held) and a liability or income.

   The IFRIC agreed that (b) applied.

2. If an asset is recognised for allowances held, whether that asset should be accounted for as (a) a financial asset under IAS 39 *Financial Instruments: Recognition and Measurement*; or (b) an intangible asset under IAS 38 *Intangible Assets*.

   The IFRIC agreed that the asset is an intangible asset that falls within IAS 38. It discussed whether it should ask the Board to amend IAS 38 to require allowances and other intangible assets that are traded in a liquid market to be measured at fair value with changes in fair value being recognised in the income statement. It decided not to pursue this approach given the Board’s project on Reporting Financial Performance.

3. If a separate liability/income is recognised, whether that represents (a) the deferral of any element of grant under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, (b) the obligation to reduce emissions, return allowances or pay a penalty, or (c) income.

(continued ...)

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The IFRIC agreed that, under IAS 37, an 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. The IFRIC agreed that when allowances are allocated for less than fair value (eg free of charge), there is an element of government grant that would be accounted for as a deferred credit under IAS 20. It also decided that both the asset and the grant should be measured on initial recognition at fair value and not at nil. The IFRIC noted that the Board will review IAS 20 in its Convergence project and may propose an approach under which only liabilities (and not deferred credits) would be reported in the balance sheet. In this case, the IFRIC decided that the terms of an emission rights scheme may give rise to a liability at the time allowances are delivered—eg to operate at some minimal level of production necessary to avoid a requirement to return the allowances. To the extent there is no such liability under the terms of the scheme, income should be recognised.

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.

New agenda items

The IFRIC discussed the following new agenda items:

Decommissioning funds

Some companies have obligations to decommission assets or for environmental rehabilitation that are recognised as provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In some cases, the company contributes to a fund established to reimburse the decommissioning costs when they are incurred. The fund may be set up to meet the decommissioning costs of a single contributor, or for several contributors.

The IFRIC agreed to add the accounting treatment of such funds to its agenda. It then discussed the following four main accounting issues:

1. Should any of the different types of funds be consolidated by contributors? The IFRIC agreed that relevant considerations include the extent to which the contributor has the ability to determine investment decisions of the fund (eg by determining the appointment of the fund's trustees), and the extent to which the contributor bears the benefits and risks of the fund's assets. The IFRIC agree that the issue of whether there is joint control or significant influence should also be addressed.

2. If the funds are not consolidated, do they give rise to (a) a net asset or liability (being the net of the attributable fund assets and the decommissioning obligation) or (b) a separate asset (rights to the fund's assets) and a liability (the decommissioning obligation)? The IFRIC agreed that, since these funds do not relieve the contributor of its obligation to decommission, a separate asset and a liability should be recognised.

3. In a case where, if a contributor becomes bankrupt and is unable to make its scheduled contributions, the future contributions of all other contributors are increased, what is the nature of the potential additional liability that will arise on the bankruptcy of another contributor? The IFRIC agreed that the potential additional liability is a contingent obligation that is within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

4. If a separate asset is recognised under issue 2 above, what is the nature of that asset? The IFRIC discussed whether the asset is in the nature of a reimbursement to be accounted for under paragraph 53 of IAS 37, whether it is a financial asset and if so how it would be classified under IAS 39 *Financial Instruments: Recognition and Measurement*.

The IFRIC also noted that such funds have some similarities to pension funds and agreed to consider whether they might be accounted for in a manner analogous to that in IAS 19 *Employee Benefits*.

The IFRIC agreed to continue its discussions at a future meeting.

Possible amendment to SIC-12

The Board has recently begun a project on consolidation policies and practices, including their application to special purpose entities (SPEs). This project is likely to result in a replacement of both IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* and SIC-12 *Consolidation – Special Purpose Entities* in due course. However, a new Standard is unlikely to be issued for some time.

The Board last discussed this project at its October meeting, when it asked the IFRIC to explore whether an appropriate interim solution would be for IFRIC to make a limited amendment to SIC-12. The amendment would clarify that a 'majority' of benefits or risks (in SIC-12 paragraph 10(c) and (d)) is intended to refer to exposure to the majority of the *variability* of expected economic outcome, rather than the *absolute* economic outcome. One aim of making such an amendment would be convergence towards the approach the FASB has been developing in its project on SPEs.

The IFRIC decided, for a variety of reasons, not to recommend such an amendment to SIC-12. It noted that SIC-12 is not interpreted in practice as referring to absolute economic outcome, so the limited amendment proposed would likely have little, if any, practical effect. In addition, the IFRIC noted that there are difficult issues about exactly what is meant by variability of outcome, as well as other issues about the interpretation of SIC-12, that the IFRIC believes are best resolved by the Board in its project. Finally, the IFRIC noted that the FASB's approach is still being finalised and that it could be premature to amend

SIC-12 in any partial manner. The IFRIC's analysis is to be reported to the Board.

IAS 37 – Changes in decommissioning liabilities

The IFRIC considered the accounting for changes in a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for expenditures required to settle an obligation to decommission an asset. In particular, it considered the accounting for the effect of the following changes:

- the unwinding of the discount.
- a change in the risk-free interest component of the discount rate.
- a change in the risk premium component of the discount rate.
- the effect of technological advancement that decreases estimated cash flows.
- the effect of a new environmental law that causes an increase in estimated cash flows.

The IFRIC tentatively agreed that:

- The unwinding of the discount as referred to in paragraph 60 of IAS 37 should be reported in profit or loss. It would not be appropriate to capitalise the unwinding of the discount under paragraph 11 of IAS 23 *Borrowing Costs,* since it is not a borrowing cost as defined in that Standard.
- The other changes described above (ie changes in the discount rate and the estimated cash flows to settle the obligation) should:

  (a) be added to (or deducted from) the amount capitalised as an asset to the extent they relate to future periods; and

  (b) reported as income or expense to the extent they relate to the current or prior periods.

This treatment is consistent with accounting for a change in accounting estimate in IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies.*

The IFRIC staff will draft an Interpretation for consideration at the next meeting.

IAS 19 – money purchase plan with minimum guarantee

The IFRIC considered how to apply IAS 19 to 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.

The IFRIC agreed that it would be desirable to issue guidance on how to account for this type of plan. The IFRIC instructed the staff to explore in greater depth all the approaches that could be adopted, in particular the possibility of measuring the guarantee directly under IAS 39 or IAS 37, leaving only a defined contribution plan to be accounted for under IAS 19. The IFRIC noted the staff's concern that this might lead to companies seeking to separate guarantees and derivatives embedded in other plans where this might be less appropriate and asked the staff to consider how any guidance on when to separate might be limited. In particular, it was suggested that a guarantee of final salary should not be accounted for separately, but as an integral part of a defined benefits plan.

IAS 19- multi-employer exemption

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 whether to issue guidance on when these criteria might be met. It agreed that it would be helpful to issue an Interpretation as long as useful additional guidance could be developed. Simply repeating or emphasising the existing requirement would not be appropriate.

Hyperinflation

Accounting for inflation is dealt with in IAS 15 *Information Reflecting the Effects of Changing Prices* and IAS 29 *Financial Reporting in Hyperinflationary Economies*. IAS 15 encourages the voluntarily provision of supplementary information on changing prices, whereas IAS 29 requires the financial statements to be restated when certain criteria of hyperinflation are met. The Board proposed in its Improvements project to withdraw IAS 15.

The IFRIC discussed various issues regarding accounting for high and hyperinflation, to provide the Board with input to the Improvements and Convergence projects, including:

- the potential absence of guidance on accounting for high inflation in the context of the proposed withdrawal of IAS 15
- determining when an economy is hyperinflationary
- practical matters raised with the IFRIC Agenda Committee, including what constitutes a general price index and presentation of comparative figures on first adopting IAS 29.

The IFRIC agreed that these issues are beyond interpretation and should be addressed by the Board in its Improvements and Convergence projects. The IFRIC also agreed on a number of specific recommendations for the Board to consider in these projects.

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Future meetings and requests for Interpretations

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

4 - 5 February

1 - 2 April

1 - 2 July

30 - 31 July

30 September - 1 October

2 - 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.