NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

May 2004

The International Financial Reporting Interpretations Committee met in London on 4 and 5 May 2004, when it discussed:

- Interpretation 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*
- IFRS 2: Accounting for share ownership plans
- IAS 27: Fiduciaries and control
- IAS 32: Members' shares in co-operative entities
- IAS 41: Recognition and measurement of biological assets
- Sale and leasebacks with repurchase agreements
- Service concession arrangements
- IFRIC D3: Comment letter analysis
- IFRIC D4: Comment letter analysis

Discussion of the activities of other interpretation bodies was deferred until the June 2004 meeting.

Members' shares in co-operative entities

The IFRIC discussed specific issues relating to the draft interpretation on whether, in accordance with IAS 32 *Financial Instruments: Disclosure and Presentation*, members' shares in a co-operative bank should be classified as debt or equity.

In particular the IFRIC came to the following decisions:

(a) It agreed to a change in the scope of the draft interpretation whereby the draft interpretation now applied to instruments within the scope of IAS 32, including (but not limited to) instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity.

(b) A committee member raised the concern that the classification as debt or equity might depend on management decision when the classification is impacted by limitations in the governing charter. The IFRIC noted that since alterations to the governing charter cannot normally be done unilaterally, ie without the consent of the members, this would prevent potential abuse of the proposals in the draft interpretation.

(c) The draft interpretation proposes that members' shares are equity to the extent of prohibitions imposed by local law, regulation, or the entity's governing charter against redemption. It goes on to state that a prohibition may be absolute or proportional and members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption. The draft interpretation also proposes that where the number of shares or amount of paid in capital subject to prohibition changes from time to time, the entity reclassifies amounts between liabilities and equity, based on the redemption amount of the members' shares reclassified, and does not recognise gain or loss. The IFRIC discussed and tentatively agreed these proposals.

(d) The IFRIC debated the measurement of liability and equity when members' shares that are subject to an overall redemption prohibition are issued at different values. The IFRIC tentatively decided that, if the shares to which the prohibition applies are not specifically identified, an entity would recognise the liability for the redemption obligation at the maximum amount that might become payable under the redemption provisions contained in the governing charter. It also tentatively agreed to clarify that there would no gain or loss on any reclassification between liability and equity.

(e) The IFRIC tentatively agreed to require disclosure when a change in the overall redemption prohibition leads to a reclassification between liabilities and equity.

(f) The IFRIC tentatively agreed to include an example that demonstrates the mechanics of the decisions outlined in paragraphs (c) and (d) above.

(g) The IFRIC noted that the interpretation deals with portfolios of financial instruments while IAS 32 refers to individual instruments. It debated whether it could apply the requirements in IAS 32 to a portfolio of financial instruments or whether such an interpretation would require an amendment to IAS 32. The IFRIC tentatively agreed that it could interpret the requirements in IAS 32 to be applicable to portfolios and that this did not require an amendment to IAS 32. It decided to include in the Basis for Conclusions on the draft interpretation the reasons behind this conclusion.

The IFRIC unanimously voted in favour of publishing the draft interpretation as an exposure draft subject to review by IFRIC members of drafting changes needed to incorporate points raised during the meeting.

IFRIC Update is published immediately after every IFRIC meeting by the International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom.

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IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*

The IFRIC was informed that the Board had concluded at its April meeting that it would not need to re-expose the consequential adjustment to IFRS 1 that allowed first-time adopters to adopt a simpler approach to dealing with changes in liabilities before the date of transition to IFRS (see *IASB Update*, April 2004). Subject to the Board's balloting of that consequential amendment, IFRIC 1 is expected to be published towards the end of May.

IFRS 2 *Share-based Payment*: Employee benefit trusts

The IFRIC began discussing issues concerning employee benefit trusts (or similar entities) that are set up to hold the sponsoring entity's shares for later transfer to the sponsoring entity's employees under a share-based payment arrangement within the scope of IFRS 2 *Share-based Payment*.

When IFRS 2 becomes effective, it amends IAS 19 *Employee Benefits* by:

(a) removing from its scope employee benefits to which IFRS 2 applies, and

(b) removing all references to equity compensation benefits and equity compensation plans.

SIC-12 *Consolidation–Special Purpose Entities* states that it does not apply to post-employment benefit plans or equity compensation plans (SIC-12 paragraph 6). During the IASB's deliberations when finalising IFRS 2, it agreed to ask IFRIC to consider:

(a) whether the scope exclusion in SIC-12 for equity compensation plans should be removed when IFRS 2 becomes effective, and

(b) whether any guidance should be provided on accounting for employee benefit trusts relating to share-based payment arrangements.

The IFRIC agreed that the above issues should be addressed in two steps, with the first step being the proposal to remove from SIC-12 the scope exclusion for equity compensation plans.

The IFRIC also discussed the scope exclusion in SIC-12 for post-retirement benefit plans, in particular, its alignment with the employee benefits plans within the scope of IAS 19. The IFRIC directed the staff to prepare a paper for the next meeting addressing whether the scope of SIC-12 should be revised to exclude all long-term employee benefit plans within the scope of IAS 19.

IAS 27: Fiduciaries and control

The IFRIC gave preliminary consideration to a recommendation from the Agenda Committee to look at aspects of how the definition of control applied to those who control resources on behalf of others (referred to as 'fiduciaries'). The Agenda Committee's recommendation was made in the knowledge that the Board would be considering more generally the position of fiduciaries in the consolidations project at its May meeting. The limited proposal in front of IFRIC was intended only to be a short-term project to clarify the relationship between operational or delegated control and ultimate control. A draft consensus was considered that included a number of examples.

The IFRIC did not think that the limited approach proposed would be particularly useful for the majority of fund manager situations with which they were familiar. Concern was also expressed that unless the fact patterns covered were sufficiently specific there was a danger that structuring would be encouraged. The IFRIC raised various issues (eg how to consider situations in which delegated and direct control co-exist) that coincided with those covered in the broader May Board paper. In view of this it was agreed that it would be better to revisit the issue in June once the Board had discussed this issue and it was clearer whether any form of interim consensus would be useful.

IAS 41 *Agriculture*: Recognition and measurement of biological assets

The IFRIC considered a draft Exposure Draft of proposed amendments to IAS 41 *Agriculture*, including the following issues:

- how to determine the fair value of a biological asset.
- how to account for a legal or constructive obligation to re-establish a biological asset after harvest.

Determining fair value

The IFRIC has been considering how an entity should use a discounting model if it determines fair value of a biological asset based on expected cash flows. At this meeting the IFRIC agreed to recommend to the Board that the Board should:

- amend IAS 41 to clarify which value in which market would be relevant to establish fair value, emphasising that the asset held must be the focal point.
- establish a fair value hierarchy in IAS 41 that is consistent with other standards.
- clarify that when fair value is determined by using valuation techniques an entity should incorporate assumptions that market participants would use on the basis of facts or information known or knowable as of the measurement date unless impracticable.
- retain the requirement that the recognised value of a biological asset should reflect the asset's present condition and location, ie the asset should be measured at its fair value less transport and other costs of getting the asset to the market and less other costs to sell.
- conform the terminology in IAS 41 to other Standards.

The IFRIC in its discussion considered a draft Exposure Draft of a revised IAS 41. Although the IFRIC generally agreed with the view that the fair value guidance in IAS 41 need to be clarified/updated, the IFRIC expressed concerns about the proposed introduction of the term 'highest and best use'.

The IFRIC noted that there are two issues that need to be considered. First, if there is no active market in a biological asset's current condition, should an entity determine fair value of that asset as the present value of a future market price? For example, if there is no active market for two-year trees but there is one for ten-year trees, should an entity at the balance sheet date determine the fair value of two-year trees based on a discounting of the market price for ten-year trees? Secondly, which market should be used if two or more markets exist for a biological asset?

The IFRIC noted that the proposed changes in the guidance for determining fair value are (partly) generic in nature and would have broader implications that should be made only as a result of Board consideration. The IFRIC therefore agreed to recommend to the Board that it should take the project on to its agenda. For this purpose, the IFRIC requested that the staff modify the draft Exposure Draft and prepare a discussion paper highlighting the issues that the Board needs to consider in relation to the guidance for determining fair value.

Obligation to replant

The IFRIC confirmed its previous decision that if an entity has an obligation to re-establish a biological asset after harvest, that obligation is attached to the land and, thus, does not affect the fair value of the biological assets currently growing on the land. The IFRIC also confirmed that harvest is the triggering event; in other words, if an entity does not harvest, there is no present liability. Therefore, an entity should recognise a liability to replant at harvest only.

The IFRIC observed that, in some instances, an entity may have an obligation to replant a biological asset but the entity will not always have ownership of the new biological asset created by replanting (and therefore not be able to benefit from the replanting). This could, for example, be the case in some leases of land. It was noted, however, that such an obligation would be similar to other hand-back obligations included in leasing agreements, the accounting for which should be determining by the leasing standard and general requirements for liabilities. The IFRIC therefore agreed not to consider this issue as part of its agriculture project.

Sale and leasebacks with repurchase agreements

In connection with its work on service concession arrangements (*see below*) the IFRIC has agreed that no sale should be recognised in a sale and leaseback containing a repurchase agreement (including an option), if the seller retains significant risks or rewards under the repurchase agreement. This is because a sale containing such a repurchase agreement is not a sale under IAS 18 *Revenue*.

The IFRIC has tentatively agreed that this should be the subject of an interpretation, which would apply in all cases, including other linked transactions that have a similar effect. It would not be restricted to service concession arrangements.

Service concession arrangements

At its March meeting, the IFRIC agreed on a list of issues that should be addressed in relation to service concessions. The IFRIC considered a framework, in the form of a flowchart, within which staff proposed to develop interpretations on those issues. It was envisaged that some interpretations might apply more widely than to service concessions, and that separate interpretations might be developed on at least some of the topics. It would then be necessary to publish guidance on how the interpretations should be brought together and applied to service concessions.

The framework focused on the accounting by the concession operator (CO), and proposed that the first step would be to determine whether CO should recognise the physical infrastructure assets as its own.

- If it should, the IFRIC had previously agreed that CO would be maintaining, operating and (if applicable) building the assets for itself, so there would no construction and services contract to account for. IAS 16 *Property, Plant and Equipment* would be applied to the assets in the usual way.
- If CO should not recognise the assets, IAS 11 *Construction Contracts* and IAS 18 *Revenue* should be applied to the contract. Issues on combining and segmenting contracts, which the IFRIC had asked staff to consider further, would then be relevant. CO's asset might typically, in this case, be either a receivable or an intangible.
- In both cases it would also be necessary to consider the treatment of other rights and obligations, including rights to recover finance costs and obligations to hand over assets to the concession provider (CP) at the end of the concession.

The flowchart will be developed further and may be published in *IFRIC Update* after the IFRIC's next meeting.

Recognition of the physical asset

The IFRIC considered an analysis of which party should recognise the physical asset as its own, which was based principally on the risks and rewards approach in IAS 17 *Leases* and IAS 18 *Revenue*. The overall effect of its recommendations would generally be that assets would be recognised by CP rather than CO, unless CO has substantially all of the risks and rewards incidental to ownership. Many IFRIC members were concerned about the emphasis on risks and rewards rather than control, and staff undertook to re-analyse the issues with more emphasis on control.

In relation to the risks and rewards analysis, the IFRIC agreed that:

- A sale and repurchase agreement in which the seller retains significant risks or rewards under the repurchase agreement (eg via an option) is not a sale for the purpose of IAS 18 and may constitute an operating lease from the "seller" to the "buyer" under IAS 17. As a result, land and long-lived infrastructure assets "sold" by CP to CO at the start of a concession, and reacquired at the end, would typically be accounted for throughout as assets of CP.

- This remains true if there are other linked transactions, such as leasebacks. Therefore, no sale should be recognised in a sale and leaseback containing a repurchase agreement (including an option), if the seller retains significant risks or rewards under the repurchase agreement. The IFRIC tentatively agreed that this should be the subject of an interpretation, which would not be restricted to service concession arrangements.
- The IFRIC also considered whether, if CO builds property on land that is recognised as an asset of CP, that property should be recognised as an asset of CP. It did not reach agreement on this point, but expected that further analysis based on control would enable a conclusion to be reached.

Combining and segmenting service concession contracts

The IFRIC discussed whether it would be appropriate to segment the construction and services components of a service concession contract where they have substantially different margins.

The IFRIC discussed an analysis of IAS 11 and IAS 18, which suggested that this could, and in appropriate cases should, be done without having to satisfy the criteria in IAS 11 for segmenting a contract. Under IASs 11 and 18, costs are recognised as expenses as incurred, unless they relate to future activity. Revenues are recognised using the method that measures reliably the work or services performed. If output measures of revenue are used, and different outputs have different margins associated with them, this will result in a non-uniform margin, similar to that which would result if the contract was segmented. The IFRIC asked for the project on combining and segmenting construction contracts to be extended to consider this issue further, with a view to reaching an interpretation that would be consistent across both IASs 11 and 18. The IFRIC noted that, if the analysis is correct, there may be convergence issues with US GAAP.

Overall issues

At the end of its discussion on service concession arrangements, the IFRIC noted that there seemed to be three possible accounting models being put forward. These could be illustrated with an example (which ignores interest). Suppose that CO builds a road at a cost of 100, its construction profit (if any) is 10, and total cash inflows over the life of the concession are 200:

- If CO recognises the road as its asset, CO has no construction revenue. It has 200 of revenue over the life of the concession.
- If CO's asset is a receivable (for example, if CO receives fixed payments from CP over the life of the concession), CO recognises construction revenue of 110. The receivable is settled 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.
- If CO's asset is an intangible (which staff has suggested may be the case if CO has demand risk), then the staff are suggesting that CO is providing construction services of 110 in exchange for the intangible asset which is recognised at a cost of 110. There is construction revenue of 110. 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.

In the third case, some IFRIC members were uncomfortable with the recognition of construction profit, and/or with the recognition of aggregate revenues in excess of the cash inflows of 200. The IFRIC asked staff to prepare a paper on the nature of the concession operator's asset, and its implications for revenue, in various situations for consideration at its June meeting.

IFRIC D3: Comment letter analysis

The IFRIC began its consideration of comments received in response to the exposure of D3 *Determining whether an Arrangement contains a Lease*, issued in January 2004. (Draft Interpretation D3 and comment letters thereon can be found under 'Current Issues' on the IASB's Website.) At this meeting, the IFRIC focused on comments relating to the three criteria contained in D3 for determining whether an arrangement is, or contains, a lease.

The IFRIC noted that while the majority of respondents to D3 broadly supported the criteria for determining whether a lease exists, a significant proportion (which included the majority of preparers) disagreed. Respondents who disagreed mainly argued that D3 captures arrangements that are not economically similar to leases. Some of the respondents who disagreed proposed amendments to the criteria in order to limit the types of arrangements that would be regarded as containing leases, whilst others suggested that the IFRIC limit the objective of D3 and require only fuller disclosure of commitments under executory contracts.

The IFRIC noted that the point of most contention in D3 was the proposal that a right to use can be conveyed in an arrangement in which one party is acquiring all (or substantially all) of the output from a specifically identified asset, regardless of whether that party has the ability to operate that asset. In the view of some respondents, a right to use implies a right to operate the underlying asset or direct others to operate that asset. In support of this view, some respondents noted a right to operate the underlying asset is a criterion in EITF Abstract 01-8 *Determining Whether an Arrangement Contains a Lease*. They therefore recommended that the IFRIC adopt a similar criterion in D3.

In considering the comments received, the IFRIC observed that some commentators appeared to misunderstand that D3 relates only to whether a lease exists in an arrangement and does not address whether any lease that exists should be classified as a finance or operating lease in accordance with IAS 17. Therefore, whilst an arrangement for all of the output from a specific asset may contain a lease under D3, an entity needs to assess whether the arrangement transfers substantially all the risks and rewards incidental to ownership in order to determine whether the lease should be classified as an operating or a finance lease.

The IFRIC also observed that the criterion in EITF 01-8 relating to whether an entity has the ability or right to operate (or direct others to operate) the underlying asset in the arrangement is only one of three criteria and that meeting any one of these criteria would indicate that an arrangement conveys a right to use and hence may contain a lease. In other words, it is not a prerequisite for there to be a lease.

The IFRIC tentatively agreed to proceed with this agenda item. The IFRIC directed the staff to consider further whether (i) the criteria in D3 would result in certain arrangements hitherto regarded as leases no longer being regarded as such and (ii) some arrangements would be regarded as leases under EITF 01-8 but not under D3. The IFRIC also suggested that the staff try to engage directly with a number of preparers to explore their concerns and to understand how they perceive the differences between D3 and EITF 01-8.

The IFRIC will continue its redeliberations of the criteria in D3 at a subsequent meeting as well as considering comments relating to other aspects of D3 (for example: components, the approach to reassessing whether an arrangement contains a lease and implementation requirements).

IFRIC D4: Comment letter analysis

The IFRIC considered an analysis of the main points and issues raised in the comment letters received on D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*, issued in January 2004. (Draft Interpretation D4 and comment letters thereon can be found under 'Current Issues' on the IASB's Website.)

The IFRIC confirmed that it would:

- issue guidance on the accounting for interests in decommissioning, restoration and environmental rehabilitation funds;
- retain as the scope of the Interpretation funds that segregate assets to fund some or all of the costs of decommissioning, restoration or environmental rehabilitation;
- amend the title of the Interpretation so as to reflect better the subject matter of the Interpretation.

The IFRIC discussed the comments received from respondents about the "asset cap" that is imposed by the proposed requirement in paragraph 7 of D4. This asset cap would limit the amount recognised as a reimbursement asset to the amount of the decommissioning obligation recognised. The IFRIC noted that this asset cap reflected a requirement in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. It is relevant when a contributor has the right to benefit from assets in the fund that exceed the decommissioning obligation recognised through reduced future contributions or increased reimbursements (eg by adding additional sites to the arrangement). IFRIC members expressed differing views on whether such a benefit should be recognised as an asset and, if so, whether it is an additional asset separate from the reimbursement asset. In particular, some members expressed concern that recognising a separate asset could result in only a part of the contributor's interest in a decommissioning fund being measured in accordance with IAS 37.

The IFRIC directed the staff to reconsider the proposed accounting for the reimbursement right, including the accounting for any potential additional asset. It asked the staff to consider, for discussion at a future meeting, whether the right should be accounted for under IAS 39 or IAS 37 and, in the latter case, to explore whether the asset cap should be applied.

Future meetings and requests for Interpretations

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

3 and 4 June 2004

29 and 30 July 2004

7 and 8 October 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.

