NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

January 2008

IFRIC Update *is published as a convenience to the IASB's constituents. All conclusions reported are tentative and may be changed or modified at future IFRIC meetings.*

Decisions become final only after the IFRIC has taken a formal vote on an Interpretation or Draft Interpretation, which is confirmed by the IASB.

The IFRIC met in London on 10 and 11 January 2008, when it discussed:

- IFRIC D21 *Real Estate Sales*
- IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*
- IAS 19 *Employee Benefits*—Settlements
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Deposits on returnable containers
- IFRIC agenda decisions
- Tentative agenda decisions
- IFRIC work in progress

IFRIC D21 *Real Estate Sales*

The IFRIC considered comments received on Draft Interpretation D21 that it published for comment in July 2007. Most respondents to D21 supported the IFRIC's conclusion that it should develop an interpretation on this issue. However, nearly all respondents expressed concern with some aspects of the proposals or the possible application by analogy to industries other than real estate. At this meeting, the staff presented an analysis of these concerns and asked IFRIC members to focus on issues within the scope of real estate sales. Issues arising if the scope of the project were widened will be considered at a future meeting.

In its consensus, D21 lists typical features to help determine whether a real estate sale agreement entered into before construction is complete should be regarded as a construction contract within the scope of IAS 11 *Construction Contracts* or an agreement for the sale of goods within the scope of IAS 18 *Revenue*. The IFRIC noted that respondents to D21 had mixed views about these features. Some respondents supported the indicator in paragraph 9(a) but not that in paragraph 9(b), or vice versa. Respondents also expressed concern with the wording in D21 because they understood that either indicator 9(a) or 9(b) was predominant, or that both needed to be met for a real estate sale agreement to meet the definition of a construction contract. They asked the IFRIC to clarify paragraphs 9 and 10 of D21, their interaction and the basis for conclusions to explain better the principles leading to the consensus.

The staff presented a paper with proposals that aimed to address most of these concerns, including drafting suggestions and the addition of illustrative examples to the draft interpretation. For instance, the staff proposed to clarify the wording of D21 to reflect more closely the IFRIC's conclusion at its meeting in May 2007 that either indicator 9(a) or 9(b) might on its own be a sufficient basis for a judgement that the real estate sale agreement meets the definition of a construction contract.

The IFRIC noted that the analysis of the comments received indicated that the draft interpretation was not clear.

It also noted that the draft interpretation appeared to be more rule-driven than principle-based, which is not how the IFRIC wished to proceed with this project.

Some restructuring and rewording of the draft interpretation was suggested, in particular:

- the principles should be set out clearly and more prominently in the final interpretation;
- the main body of the interpretation should include some of the wording in the Basis for Conclusions where this was considered to explain the principle more clearly; and
- the existing wording should be reordered and restructured of the existing wording.

The IFRIC directed the staff to develop a flowchart to illustrate the accounting for real estate sale agreements in accordance with IAS 18 and IAS 11, with the starting point being to consider the substance of the agreement in accordance with IAS 18.

The staff will prepare a paper for the next IFRIC meeting. No decisions were made at this meeting.

IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*

The IFRIC considered comments received on Draft Interpretation D22 that it published for comment in July 2007. Most respondents to D22 supported the IFRIC's conclusion that it should develop an interpretation on this issue and agreed with the IFRIC's proposals. However, many respondents asked for clarification about the application of those proposals to specific circumstances. At this meeting, the staff asked the IFRIC to deliberate and reconfirm the main issues in the draft interpretation. In particular, the IFRIC considered:

(i) Which parent entity (immediate, intermediate, ultimate) can hedge its net investment risk?

(ii) What can be hedged? (how to determine the amount of net investment eligible for hedge accounting).

(iii) Where can the hedging instrument be held? (how to determine hedge effectiveness).

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ISSN 1477-206X

IFRIC D22 *Hedges of a Net Investment in a Foreign Operation* (cont'd)

On the first issue, the IFRIC noted that the draft interpretation does not clearly state the financial statements to which its guidance relates (either consolidated or separate); this will need to be clarified in the final interpretation. For consolidated financial statements, the IFRIC confirmed its previous decision that any parent entity (immediate, intermediate, ultimate) may hedge its net investment. The IFRIC also confirmed that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once.

On the second issue, the IFRIC confirmed its previous decisions about what can be hedged:

- The interpretation should, as a start, explicitly require compliance with the documentation and designation requirements of IAS 39, ensuring that each risk to be hedged and hedging instrument is clearly identified.
- The amount of net investment eligible to be hedged at each parent level depends on whether any lower level parent companies have already hedged the net assets of their foreign operations (ie the amount of net investment to be hedged cannot be duplicated in the consolidated financial statements).
- A parent entity can hedge a net investment it holds indirectly.

The IFRIC also confirmed the importance of clearly documenting the group's hedging strategy, the hedged item and the hedging instrument in order to qualify for hedge accounting. The IFRIC also confirmed that determining which financial statements are being prepared is critical to the documentation.

The IFRIC noted that many of the problems identified by respondents could be solved by clarifying the terminology in the interpretation. The staff will therefore pay particular attention to clear and consistent terminology in redrafting the interpretation.

On the third issue, the IFRIC confirmed its previous conclusion that for the purpose of assessing hedge effectiveness, any entity in the group may hold the hedging instrument. In the IFRIC's view, this conclusion is in accordance with the objective of hedging of a net investment in IAS 39 *Financial Instruments: Recognition and Measurement*. However, the IFRIC agreed with the staff analysis that the conclusion should be based on the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, IAS 39 and IAS 1 *Presentation of Financial Statements* (as revised in 2007) rather than referring to IAS 39 Implementation Question F.2.14 by analogy.

The IFRIC directed the staff to prepare a comprehensive example to illustrate its conclusions on the second and third issues, including the effect of hedge accounting in different situations and using different consolidation methods. This example should be prepared in sufficient time in advance of the next meeting to allow a full review by IFRIC members. It will be considered in detail before the IFRIC makes any further decisions on the interpretation.

IAS 19 *Employee Benefits*—Settlements

The IFRIC discussed whether to add to its agenda a question about whether some payments of benefits under a defined benefit plan are settlements as defined in IAS 19. The payments in question arise when the existing terms of a plan give plan members the option to receive some or all of their benefits as a lump sum payment at retirement instead of as ongoing payments.

The IFRIC noted that in many jurisdictions a consistent treatment had developed under IAS 19 of not treating such payments as settlements. IFRIC members reported little diversity in practice. However, the IFRIC also noted that the wording in IAS 19 could be interpreted as including such payments in the definition of a settlement and that they would be treated as settlements under the US standard SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. The IFRIC instructed the staff to consult in order to understand the effect of any proposed changes arising from a clarification of the definition of a settlement.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Deposits on returnable containers

At its meeting in November 2007, the IFRIC discussed a request for guidance to be issued on the accounting for the obligation to refund deposits on returnable containers. In some industries, entities that distribute their products in returnable containers collect a deposit for each container delivered and have an obligation to refund this deposit when containers are returned by the customer. The issue is whether the obligation should be accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.*

In the November 2007 *IFRIC Update*, the IFRIC published a tentative agenda decision proposing not to add the item to its agenda on the basis that divergence in this area was not expected to be significant.

The IFRIC received two comment letters. Both respondents agreed that the IFRIC should not add the issue to its agenda. However, one respondent did not agree with the rationale for that conclusion. This respondent argued that, when the containers are not sold to the customer and remain the assets of the entity, the obligation to refund the deposit is not an executory contract but a financial liability within the scope of IAS 39.

Whilst the IFRIC did not change its decision not to add the issue to its agenda, it did not agree on wording for that decision. The IFRIC therefore asked the staff to present a paper to the next meeting with amended wording for its agenda decision.

IFRIC agenda decisions

The following explanations are published for information only and do not change existing IFRS requirements. *IFRIC agenda decisions are not Interpretations. Interpretations of the IFRIC are determined only after extensive deliberation and due process, including a formal vote. IFRIC Interpretations become final only when approved by nine of the fourteen members of the IASB.*

IAS 19 *Employee Benefits*—Death in service benefits

An entity may provide payments to employees if they die while employed ('death in service' benefits). In some situations, IAS 19 requires these benefits to be attributed to periods of service using the Projected Unit Credit Method. The IFRIC received a request for guidance on how an entity should attribute these benefits to periods of service. The request noted that different treatments existed in practice.

The IFRIC noted that paragraph 67(b) of IAS 19 requires attribution of the cost of the benefits until the date 'when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.'

In the case of death in service benefits, the IFRIC noted that:

- the anticipated date of death would be the date at which no material amount of further benefit would arise from the plan;
- using different mortality assumptions for a defined benefit pension plan and an associated death in service benefit would not comply with the requirement in paragraph 72 of IAS 19 to use actuarial assumptions that are mutually compatible; and
- if the conditions in paragraph 39 of IAS 19 were met then accounting for death in service benefits on a defined contribution basis would be appropriate.

The IFRIC concluded that divergence in this area was unlikely to be significant. In addition, any further guidance that it could issue would be application guidance on the use of the Projected Unit Credit Method. The IFRIC therefore decided not to add the issue to its agenda.

IAS 19 *Employee Benefits*—Definition of plan assets

The IFRIC received a request for guidance on the accounting for investment or insurance policies that are issued by an entity to a pension plan covering its own employees (or the employees of an entity that is consolidated in the same group as the entity issuing the policy). The request asked for guidance on whether such policies would be part of plan assets in the consolidated and separate financial statements of the sponsor.

The IFRIC noted the definitions of plan assets, assets held by a long-term employee benefit fund and a qualifying insurance policy in IAS 19 paragraph 7. The IFRIC noted that, if a policy was issued by a group company to the employee benefit fund then the treatment would depend upon whether the policy was a 'non-transferable financial instrument issued by the reporting entity'. Since the policy was issued by a related party, it could not meet the definition of a qualifying insurance policy.

The IFRIC considered that the issue was too narrow in scope to develop an Interpretation and decided not to add the issue to its agenda.

IAS 19 *Employee Benefits*—Pension promises based on performance hurdles

The IFRIC received a request to clarify the measurement of the defined benefit obligation when pension promises are based on achieving specific performance targets. Performance targets may relate to various forms of pension promises ranging from additional pensionable earnings from performance bonuses to more complex arrangements relating to additional sponsor contributions or years of deemed service. The issue is how defined benefit plans with such features should be accounted for in accordance with IAS 19.

The IFRIC noted that paragraph 73 of IAS 19 states that 'Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.' Performance targets are variables that will affect the ultimate cost of providing the post-employment benefits. They should therefore be included in the determination of the benefit.

The IFRIC also noted that paragraph 67 of IAS 19 requires benefits to be attributed to periods of service according to the benefit formula, unless an employee's service in later years will lead to a materially higher level of benefit than in earlier years. When benefits are affected by performance hurdles, the effect on the attribution of benefits must also be considered.

Given the requirements in IAS 19, the IFRIC did not expect divergence in practice and decided not to add the issue to its agenda.

IAS 23 *Borrowing Costs* (as revised in 2007)—Foreign exchange and capitalisable borrowing costs

The IFRIC received a request for guidance on which foreign exchange differences may be regarded as adjustments to interest costs for the purpose of applying IAS 23. IAS 23 states that 'Borrowing costs may include…exchange differences arising from foreign currency borrowings *to the extent* that they are regarded as an adjustment to interest costs' (emphasis added). The request asked for guidance both on the treatment of foreign exchange gains and losses and on the treatment of any derivatives used to hedge such foreign exchange exposures.

The IFRIC noted that the principle set out in paragraph 8 of IAS 23 states 'an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.' The IFRIC also noted that paragraph 11 states 'the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.' Consequently, how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring the exercise of judgement. IAS 1 *Presentation of Financial Statements* requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements.

The IFRIC noted that, notwithstanding the guidance in paragraphs 8 and 11 of IAS 23, the standard itself acknowledges that judgement will be required in its application and appropriate disclosure of accounting policies and judgements would provide users with the information they need to understand the financial statements. The IFRIC concluded that it was unnecessary to provide application guidance. The IFRIC also noted that, as part of its project to amend IAS 23, the Board specifically considered this issue and decided not to develop further guidance in this area. The IFRIC concluded that it should not develop guidance as the Board had already decided not to provide it.

The IFRIC therefore decided not to add the issue to its agenda.

IAS 39 *Financial Instruments: Recognition and Measurement*—Scope of IAS 39 paragraph 2(g)

The IFRIC received a request for guidance on the appropriate interpretation of IAS 39 paragraph 2(g). This paragraph exempts from the scope of IAS 39 'contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.' The request asked whether this scope exception applies only to binding contracts to acquire shares that constitute a controlling interest in another entity within the period necessary to complete a business combination, or if it applies more widely. The request also asked for guidance on whether the scope exception could be applied to other similar transactions, such as those to acquire an interest in an associate.

The IFRIC acknowledged that the wording in paragraph 2(g) of IAS 39 is ambiguous and could lead to diversity in practice. For this reason, the IFRIC decided to ask the Board to clarify the standard, addressing in particular:

- whether the scope exception in paragraph 2(g) applies to all contracts (including options) between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.
- whether the scope exception provided in paragraph 2(g) could be applied to similar transactions, such as those to acquire an interest in an associate.

Tentative agenda decisions

The IFRIC reviewed the following matter and tentatively decided that it should not be added to the IFRIC agenda. This tentative decision, including recommended reasons for not adding the item to the IFRIC agenda, will be reconsidered at the IFRIC meeting in March 2008. Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are encouraged to communicate those concerns by 16 February by email to: ifric@iasb.org. Please note that, owing to the short period between that deadline and the next IFRIC meeting, the IFRIC staff cannot guarantee that comments not emailed to this address or received after this date will be considered.

Communications will be placed on the public record unless the writer requests confidentiality, supported by good reason, such as commercial confidence.

IAS 7 *Statement of Cash Flows*—Classification of expenditures

The IFRIC received a request for guidance on the treatment of some types of expenditure in the statement of cash flows. In practice some entities classify expenditures that are not recognised as assets under IFRSs as cash flows from operating activities while others classify them as part of investing activities. Examples of such expenditures are those for exploration and evaluation activities (which can be recognised, according to the applicable standard, as an asset or an expense). Advertising and promotional activities, staff training and research and development could also raise the same issue.

The IFRIC concluded that the issue could be best resolved by referring it to the Board with a recommendation that IAS 7 should be amended to make explicit that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activity. The IFRIC therefore [decided] not to add the issue to its agenda.

IFRIC work in progress

The IFRIC reviewed its summary of outstanding issues. The staff noted that all but three of the active issues on the list had been discussed at this meeting. Two of those items related to Draft Interpretations that were about to be published for comment with a deadline for submitting comments of 25 April 2008. The third issue, relating to derecognition, was awaiting the allocation of staff resources.

From July 2006, IFRIC meetings have been audiocast live via the Internet. Audio recordings are available to listen to via the Website and can be accessed via the IFRIC Projects included within the Current Projects area. Please visit the IASB Website at www.iasb.org for more information.

Future IFRIC meetings

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

2008

- 6 and 7 March
- 8 and 9 May
- 10 and 11 July
- 4 and 5 September
- 6 and 7 November

In addition to the meetings listed above, the IFRIC may hold meetings for a preliminary discussion of some staff papers. Attendance by IFRIC members at these meetings is voluntary and no decisions on technical issues will be made. If the IFRIC holds a preliminary meeting, it will normally take place on the Wednesday afternoon before the IFRIC meeting.

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. Instructions for submitting requests for Interpretations are given on the IASB Website at http://www.iasb.org/About+Us/About+IFRIC/Propose+Agenda+Item.htm

