NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB

IFRIC UPDATE

May 2006

IASB MEETING, JUNE 2006
INFORMATION FOR OBSERVERS
AGENDA PAPER 5A

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 Exposure Draft, which is confirmed by the IASB.

The International Financial Reporting Interpretations Committee met in London on 11 and 12 May 2006, when it discussed:

- IAS 18 *Revenue* – Customer Loyalty Programmes
- IAS 19 *Employee Benefits* – The Effect of a Minimum Funding Requirement on the Asset Ceiling
- Service Concession Arrangements
- IAS 39 *Financial Instruments: Recognition and Measurement* – Derecognition of Groups of Financial Assets
- D17 *IFRS 2 Group and Treasury Share Transactions*
- D18 *Interim Reporting and Impairment*
- IFRS 2 *Share-based Payment* – Employee Benefit Trusts
- IAS 18 *Revenue* – Upfront Revenue Recognition
- IAS 32 *Financial Instruments: Presentation* – Classification of a Financial Instrument as Liability or Equity
- IFRS 3 *Business Combinations* – Classification of puts and forwards held by minority interests
- IFRS 2 *Share-based Payment* – Post-vesting Transfer Restrictions
- IFRIC Agenda Decisions
- Tentative Agenda Decisions

IAS 18 *Revenue* – Customer Loyalty Programmes

The IFRIC considered a draft of a Draft Interpretation on customer loyalty programmes. At the previous meeting it was decided to test the approach that the award of 'points', 'air miles' and other award credits granted to customers as part of customer loyalty programmes would be accounted for as separate components of the initial sales transaction in which the award credits are granted (ie applying paragraph 13 of IAS 18). Some of the consideration received for each initial sale would be allocated to the award credits. This consideration would be deferred and recognised as revenue when the entity fulfilled its obligations in respect of the award credits either by delivery of goods or services itself or by engaging a third party to take on the obligation.

An Interpretation requiring this method would result in consistent practices being adopted for all types of customer incentives, whether supplied as part of loyalty programmes or not, whatever the nature and form of the incentives and however they are delivered.

The IFRIC discussed a suggestion that, while the proposed approach was logical and conceptually sound, it was more complicated than recognising a liability for the expected cost of supplying the awards (ie applying paragraph 19 of IAS 18). Some members thought that the method proposed in the Draft Interpretation should not be imposed on entities unless the loyalty awards were a significant part of their business. However, it observed that the Interpretation would not apply to immaterial items and that the systems and processes required to apply the proposed method could be similar to those needed for the alternative of applying paragraph 19 of IAS 18. The IFRIC decided to proceed with development of a draft Interpretation based on applying paragraph 13 of IAS 18.

The IFRIC decided to expand the Basis for Conclusions to explain more fully its reasons for concluding that customer loyalty awards should be regarded as a separate component of the initial sale (in accordance with paragraph 13 of IAS 18), rather than a cost that should be provided for at the time of the initial sale (in accordance with paragraph 19 of IAS 18). The explanation might note that IAS 18 seeks to ensure that revenue is recognised when goods or services have been delivered to a customer. Paragraph 13 acknowledges that a single sales contract could require the delivery of two or more separately identifiable components for goods or services and that the revenue recognition criteria should be applied separately to each. It could be argued that paragraph 19 applies only if there are costs, such as installation or warranty costs, to be incurred in respect of goods or services that have *already* been delivered. In contrast, the argument could continue, awards supplied to customers who redeem credits are not costs incurred in respect of the initial goods or services delivered: they are separate goods or services delivered at a later date.

The IFRIC decided to revisit at a future meeting:

- the proposed requirements for loyalty programmes in which awards are supplied by a third-party provider (ie rather than by the entity itself).
- the implications of award credits being forfeited by customers (ie never redeemed for awards). The staff was asked to consider whether expectations regarding forfeiture rates should be factored into the

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amount of consideration allocated to the award credits; whether the allocation should subsequently be revised if forfeiture rates vary from those expected; and when (and to what extent) consideration allocated to award credits that are expected to be forfeited or turn out to be forfeited should be recognised in income.

IAS 19 *Employee Benefits* – The Effect of a Minimum Funding Requirement on the Asset Ceiling

The IFRIC continued its deliberations in respect of the effect of a Minimum Funding Requirement (MFR) on application of the asset ceiling test under IAS 19. The staff presented a revised Draft Interpretation.

The IFRIC reaffirmed the decisions made at previous meetings, in particular:

- An economic benefit does not need to be immediately realisable at the balance sheet date in order for it to be recognised as an asset available to the entity under IAS 19.
- An entity shall apply an adjustment to reduce a defined benefit asset or increase a defined benefit liability in respect of any statutory minimum funding contributions that are payable but would not be available to the entity as a refund or reduction in future contributions.
- The asset available as a refund should be recognised to the extent that, in the jurisdiction of the plan in question, there is at the balance sheet date no obstacle under contract or law that would prevent any surplus existing on the settlement of the plan liabilities from reverting to the entity, after taking into account all the costs associated with the settlement.
- The asset available as a reduction in future contributions would be reduced by the present value of future statutory minimum funding requirements.

The IFRIC noted that the above adjustment in respect of the minimum funding requirement should be presented on a net basis in the financial statements in accordance with paragraphs 54 and 58 of IAS 19.

The IFRIC also agreed the following:

- changes to the adjustment in respect of the minimum funding requirement should be recognised immediately.
- given that the adjustment will be recognised immediately, the Draft Interpretation should require full retrospective application.

The staff will present a revised draft of the Draft Interpretation at the next IFRIC meeting.

Service Concession Arrangements

The IFRIC considered the accounting guidance and rationale contained in a revised draft of D12 *Service Concession Arrangements – Determining the Accounting Model* noting the main changes from the D12 proposals:

- Infrastructure used in a service concession arrangement for the whole of its useful life ('whole of life infrastructure') is included within the scope of the revised draft. The staff was asked to test whether such inclusion broadened the scope of the Interpretation further than the IFRIC intended.
- Under the approach proposed in D12, an entity determined the appropriate accounting model by reference to whether the grantor or the user had primary responsibility to pay the operator for the services provided. The revised draft requires that an entity should recognise a financial asset to the extent that the operator has a contractual right to receive cash from or at the direction of the grantor. A right other than a contractual right to receive cash does not meet the definition of a financial asset and is within the scope of IAS 38 *Intangible Assets*. The revised draft also makes clear that some service concession arrangements will need to be bifurcated.
- In response to constituents' concerns about the scope of the Draft Interpretation, the revised draft includes an appendix to provide references to standards that might apply to arrangements falling outside the scope of the Interpretation. By this means, and through a fuller discussion in the Basis for Conclusions, the IFRIC hoped to create a better understanding of the reasons for the particular scope requirements of the Interpretation.

Subject to drafting comments to be provided to the staff, the IFRIC decided to proceed with the revised draft.

At the previous meeting the IFRIC had agreed that the Interpretation should include a scope condition that any significant residual interest should be controlled by the grantor. At this meeting, the IFRIC considered whether Application Guidance was needed on the factors against which significance should be assessed. The IFRIC decided not to give such guidance, as the relevant factors could vary from one case to another. The IFRIC asked the staff to consider replacing the term 'residual interest' by 'residual value' to be consistent with IAS 16 *Property, Plant and Equipment*.

The IFRIC decided to combine in a single Interpretation the material covered in the three draft Interpretations (D12, D13 *Service Concession Arrangements – the Financial Asset Model* and D14 *Service Concession Arrangements – the Intangible Asset Model*) and asked the staff to consider an alternative title for the Interpretation in order to convey more clearly the subject matter of the guidance.

During the course of developing the proposals in D12, the IFRIC reached the conclusion that a transaction that took the form of a sale and leaseback should not be accounted for as such if it also incorporated a repurchase agreement. The reason was that the seller/lessee would retain effective control of the asset by virtue of the repurchase agreement. Hence the criteria for recognising a sale (which are set out in paragraph 14 of IAS 18 *Revenue*) would not be met. The IFRIC decided that this conclusion would apply more widely than to service concession arrangements and that the matter should be the subject of a separate project.

The IFRIC will consider at future meetings the remaining issues from D13 and D14 and a single revised Interpretation combining the material covered in the three draft Interpretations.

IAS 39 *Financial Instruments: Recognition and Measurement* – Derecognition of Groups of Financial Assets

The IFRIC discussed the application of the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* to transfers of groups of financial assets. In practice, entities transfer groups of financial assets which often comprise non-derivative financial assets and derivatives. The question is how to apply the derecognition provisions to such groups of assets.

The IFRIC discussed the meaning of the word 'similar' in paragraph 16 of IAS 39 in relation to grouping of similar assets in the derecognition test. Paragraph 16 states that 'In paragraphs 17–26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.' The inclusion of the word 'similar' could imply that separate derecognition tests are required for assets that are not 'similar' even though they were transferred in a group in the same arrangement. If this was the case then the pass-through test in paragraph 19 of IAS 39 and the test of risks and rewards in paragraph 20 would be applied separately to the non-similar financial assets, even though they were transferred as a group.

The IFRIC discussed whether it had been the intention of the Board (evidenced by paragraph BC 53 of IAS 39) that paragraph 16 should define when the derecognition principles of IAS 39 could be applied to <u>part</u> of a financial asset (or <u>part of a group</u> of financial assets), rather than to require separate derecognition tests for non-similar financial assets being transferred in their entirety.

The IFRIC tended to the view that the wording of paragraph 16 of IAS 39 was not consistent with such intention. Accordingly, it directed the staff to consider the implications of an Interpretation which would align the wording in paragraph 16 of IAS 39 with the possible intention of the Board.

D17 *IFRS 2 Group and Treasury Share Transactions*

The IFRIC continued its deliberations on draft Interpretation D17 *Group and Treasury Share Transactions*, and in particular the items set out in paragraphs 6(c)(i) and 6(c)(ii) of D17. These paragraphs discuss how the individual or separate financial statements of a subsidiary should account for arrangements where:

- the subsidiary grants its employees rights to the equity instruments of its parent; or
- a parent grants a subsidiary's employees rights to the equity instruments of the parent.

Paragraph 3 of IFRS 2 states that the standard 'applies to transfers of equity instruments of the entity's parent, or equity instruments of another entity in the same group as the entity, to parties that have supplied goods or services to the entity'. Some members commented that this paragraph may be interpreted as requiring no more than that the individual group entity that receives services from the relevant employees should recognise a charge in its individual or separate financial statements without necessarily specifying how that charge would be measured. As acknowledged in D17, a difficulty in applying the measurement requirements of IFRS 2 is that the 'equity settled' and 'cash settled' classifications of that standard do not exactly fit the circumstances where a subsidiary's employees receive share based payments based on the shares of another entity in the group.

The IFRIC agreed that, where a subsidiary's employees received rights to the equity instruments of its parent, a charge should be recognised in the separate or individual financial statements of the subsidiary entity. The IFRIC went on to discuss several alternatives as to how to determine the charge for share based payments in the separate or individual financial statements of the subsidiary entity.

One approach discussed was to use a model similar to that used in IAS 19 *Employee Benefits*. Under that model a subsidiary entity recognises the net defined benefit cost in its separate or individual financial statements as the amount charged to it by the parent entity. Some members commented that this approach is not appropriate for share based payments as the measurement of the cost of these arrangements is less complex.

Another approach was to recognise a charge based upon an allocation of the charge (whether equity settled or cash settled) recognised in the consolidated financial statements of the group, taking into account the proportion of services received by the individual group entity.

The IFRIC requested the staff to continue to explore methods of determining the charge that should be recognised in the separate or individual financial statements of a subsidiary entity.

D18 *Interim Reporting and Impairment*

The IFRIC considered the contents of the 57 comment letters received on Draft Interpretation D18, which was issued for comment in January 2006.

D18 sought to resolve an apparent conflict between IAS 34 *Interim Reporting* and the impairment requirements of IAS 36 *Impairment of Assets* and IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 36 states that an impairment loss on goodwill should not be reversed and IAS 39 applies a similar prohibition to equity assets held for sale and unquoted equity instruments not carried at fair value because their fair value cannot be reliably measured. If such losses may not be reversed but would not have been recognised or would have been recognised at a smaller amount if the assets to which they relate had been reviewed for impairment only at a later reporting date, there appears to be a conflict with the requirement of IAS 34 that 'the frequency of an entity's reporting (annual, half-yearly or quarterly) shall not affect the measurement of its annual results'. D18 proposed that the prohibitions of reversals in IAS 36 and IAS 39 should take priority over that statement in IAS 34.

A number of respondents believed that the issue discussed in D18 should be referred to the Board. The IFRIC noted that the issue had previously been referred to the Board in November 2005 and that the Board had concluded that it 'did not favour taking on a project to amend IAS 34.' (November 2005 IASB Update).

Other respondents believed that the Interpretation should be amended to state that it is permissible to reverse impairments booked in interim financial statements under IAS 36 and IAS 39.

The IFRIC considered these comments and concerns but reached the same conclusions on them as it had previously set out in the Basis for Conclusions on D18.

It therefore decided to pursue an Interpretation largely in the form of D18 and submit a revised draft representing IFRIC's views to the Board. The Board would be made aware of the views of the respondents who believed that it, rather than the IFRIC, should take on the issue.

The IFRIC agreed that a number of changes should be made to the Draft Interpretation prior to submission to the Board:

- The effective date and transitional arrangements should be amended to make it clear that the Interpretation was not required to be applied earlier than IAS 36 and IAS 39;
- Certain amendments should be made to the draft Basis for Conclusions.

In addition, the staff was asked to consider whether the scope paragraph, which largely duplicated the statement of the issue, needed to be retained.

The IFRIC agreed that a revised Interpretation incorporating these changes should be passed to the Board as a final IFRIC position.

IFRS 2 *Share-based Payment* – Employee Benefit Trusts

The IFRIC discussed an issue relating to accounting for employee benefit trusts (or other entities) set up by a sponsoring entity specifically to facilitate the transfer of its equity instruments to its employees under a share-based payment arrangement. The issue had been submitted in connection with the amendment of SIC-12 to include within its scope SPEs established in connection with share-based payment arrangements within the scope of IFRS 2.

For the consolidated financial statements, the IFRIC noted that SIC-12 provides relevant guidance to determine whether the sponsoring entity controls the employee benefit trust. This view was also shared by most respondents to D7 Scope of SIC-12 *Consolidation - Special Purpose Entities*. The IFRIC therefore directed its attention to the separate financial statements of the sponsoring entity. For these, the IFRIC considered whether the employee benefit trust should be treated as:

- an extension of the sponsoring entity. In that view, the sponsoring entity is in substance in the same position as if it held the shares directly and therefore accounts for them in equity as treasury shares. There would be no difference between the consolidated financial statements and the separate financial statements of the sponsoring entity in respect of the employee benefit trust and the related share-based payment arrangement; or
- a separate legal entity consolidated only at group level. In that view, the sponsoring entity accounts for the investment in the employee benefit trust as an asset in its separate financial statements.

IFRIC members cited a number of difficulties arising in practice if the separate entity view is taken.

The IFRIC decided to take this issue onto the agenda and asked the staff to analyse further for the next meeting the arguments supporting these two views.

IAS 18 *Revenue* – Upfront Revenue Recognition

The IFRIC considered whether to take on a project to develop interpretive guidance on how IAS 18 should be applied to the recognition of revenue arising upon the initial sale of mutual fund units by a fund manager.

The discussion arose as a result of requests for guidance on the extent to which revenue should be recognised when a fund manager receives a non-refundable fee at the point at which an investor invests in a mutual fund, followed by regular monthly fees for managing the fund.

Divergent views exist in practice as to the extent to which a service has been provided at the point of sale of the mutual fund units and therefore whether the upfront fee should be recognised as revenue on receipt or be spread across the expected life of the investment.

The IFRIC decided to add to its agenda a project to develop guidance on the recognition of revenue in situations where an entity receives a one-off, non-refundable, upfront fee followed by regular fees in respect of services provided. The project will focus on upfront fees received by fund managers but with a view to developing guidance which can also be applied to other situations where an entity receives an upfront, non refundable fee.

IAS 32 *Financial Instruments: Presentation* – Classification of a Financial Instrument as Liability or Equity

At the March 2006 meeting, the IFRIC discussed a submission for a possible agenda item relating to the role of contractual and economic obligations in the classification of financial instruments. At that meeting the IFRIC agreed that IAS 32 *Financial Instruments: Presentation* is clear that a contractual financial obligation is necessary in order that a financial instrument be classified as a financial liability (ignoring the classification of financial instruments that may or will be settled in the issuer's own equity instruments). Such a contractual obligation could be explicitly established or could be indirectly established. However, the obligation must be established through the terms and conditions of the financial instrument.

At the March meeting the IFRIC stated that, since the Standard is clear, it would not expect diversity in practice and would not take the item onto its agenda. It therefore requested the staff to draft reasons for not adding the issue to its agenda.

At the May meeting, the IFRIC, while not disputing the effect of the standard it had accepted in March, failed to reach agreement on the reasons proposed by the staff.

IFRS 3 *Business Combinations* – Classification of puts and forwards held by minority interests

The IFRIC considered the treatment under IAS 32 and IFRS 3 of puts and forwards held by minority interests in response to a request to the IFRIC related to situations where a parent enters into a commitment through a written put or a forward purchase to acquire shares in a subsidiary held by a third party. The settlement amount might be fixed, based on fair value of the shares at the settlement date or based on a formula, such as a multiple of EBITDA or net income. This type of contract might be negotiated as part of the purchase of the majority interest or negotiated independently at a later date. Two issues that arise regularly in practice are whether the parent must recognise a liability for the amount potentially payable under the contract and whether the minority interest continues to be recognised for the minority's shares that are subject to the agreement.

The IFRIC tentatively decided not to take the item onto its agenda but deferred publishing formal wording for this until the following meeting, when it intended to address the related issue, whether puts or forwards received by minority interests in a business combination are contingent consideration.

IFRS 2 *Share-based Payment* – Post-vesting Transfer Restrictions

The IFRIC considered the tentative agenda decision published in March IFRIC Update regarding the measurement under IFRS 2 of shares granted to employees with restrictions on transfer after vesting. IFRIC members discussed a revised text in the light of comments received and suggested further amendments. The staff will consider these and bring a further text to the July IFRIC meeting.

IFRIC Agenda Decisions

The following explanations are published for information only and do not change existing IFRS requirements. 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.

IFRS 2 *Share-based Payment* – Scope of IFRS 2: Share plans with cash alternatives at the discretion of the entity

The IFRIC considered whether an employee share plan in which the employer had the choice of settlement in cash or in shares, and the amount of the settlement did not vary with changes in the share price of the entity should be treated as a share-based payment transaction within the scope of IFRS 2 *Share-based Payment*.

The IFRIC noted that IFRS 2 defines a share-based payment transaction as a transaction in which the entity receives goods or services as consideration for equity instruments of the entity or amounts that are based on the price of equity instruments of the entity.

IFRIC further noted that the definition of a share-based payment transaction does not require the exposure of the entity to be linked to movements in the share price of the entity. Moreover, it is clear that IFRS 2 contemplates share-based payment transactions in which the terms of the arrangement provide the entity with a choice of settlement, since they are specifically addressed in paragraphs 41 - 43 of IFRS 2. The IFRIC, therefore, believed that, although the amount of the settlement did not vary with changes in the share price of the entity, such share plans are share-based payment transactions in accordance with IFRS 2 since the consideration may be equity instruments of the entity.

The IFRIC also believed that, even in the extreme circumstances in which the entity was given a choice of settlement and the value of the shares that would be delivered was a fixed monetary amount, those share plans were still within the scope of IFRS 2.

The IFRIC believed that, since the requirements of IFRS 2 are clear, the issue is not expected to create significant divergence in practice. The IFRIC, therefore, decided not to take the issue onto the agenda.

IFRS 2 *Share-based Payment* – Share plans with cash alternatives at the discretion of employees: grant date and vesting periods

The IFRIC considered an employee share plan in which employees were provided a choice to have cash at one date or shares at a later date. At the date the transactions were entered into, the parties involved understood the terms and conditions of the plans including the formula that would be used to determine the amount of cash to be paid to each individual employee (or the number of shares to be delivered to each individual employee) but the exact amount of cash or number of shares would only be known at a future date. The IFRIC was asked to confirm the grant date and vesting period for such share plans.

The IFRIC noted that IFRS 2 defines grant date as the date when there is a shared understanding of the terms and conditions. Moreover, IFRS 2 does not require grant date to be the date when the exact amount of cash to be paid (or the exact number of shares to be delivered) is known to the parties involved.

The IFRIC further noted that share-based payment transactions with cash alternatives at the discretion of the counterparty are addressed in paragraphs 34 - 40 of IFRS 2. Paragraph 35 of IFRS 2 states that, if an entity has granted the counterparty the right to choose whether a share-based payment transaction is settled in cash or by issuing equity instruments, the entity has granted a compound financial instrument, which includes a debt component (ie the counterparty's right to demand cash payment) and an equity component (ie the counterparty's right to demand settlement in equity instruments). Paragraph 38 of IFRS 2 states that the entity shall account separately for goods or services received or acquired in respect of each component of the compound financial instrument. The IFRIC, therefore, believed that the vesting period of the equity component and that of the debt component should be determined separately and the vesting period of each component may be different.

The IFRIC believed that, since 'grant date' is defined in IFRS 2 and the requirements set out in paragraphs 34 - 40 of IFRS 2 are clear, the issues are not expected to create significant divergence in practice. The IFRIC, therefore, decided that the issues should not be taken onto the agenda.

Tentative Agenda Decisions

The IFRIC reviewed the following matters, which the Agenda Committee had recommended should not be taken onto the IFRIC agenda. These tentative decisions, including where appropriate recommended reasons for not adding them to the IFRIC agenda, will be re-discussed at the July 2006 IFRIC meeting. Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are welcome to communicate those concerns by 26 June 2006, preferably by email to: ifric@iasb.org or by post to:

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

IAS 17 *Leases* – Recognition of contingent rentals

The IFRIC considered a request for clarification of the requirements of IAS 17 with respect to contingent rentals. In particular, the IFRIC was asked to consider whether an estimate of contingent rentals payable/receivable under an operating lease should be included in the total lease payments/lease income to be recognised on a straight-line basis over the lease term.

The IFRIC noted that, although the standard is unclear on this issue, a consistent application is being adopted; that is, current practice is to exclude contingent rentals from the amount to be recognised on a straight-line basis over the lease term. Accordingly, the IFRIC decided not to add the issue to its agenda.

Future IFRIC meetings

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

2006

- 6 and 7 July
- 7 and 8 September
- 2 and 3 November

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 www.iasb.org/about/ifric.asp