IFRIC Meeting

Staff Paper

Agenda reference **15**

Date **January, 2010**

Project **Tentative Agenda Decision**

Topic **IFRS 1 *First-time Adoption of International Financial Reporting Standards* – Accounting for costs included in self-constructed assets on transition**

Purpose of this paper

1. The purpose of this paper is to document the staff analysis and recommendations relating to requests to consider the accounting on transition to IFRSs for costs capitalised in accordance with previous GAAP as part of self-constructed assets.

2. These costs may be part of plant and equipment, inventory, intangible assets or construction contract costs at the date of application of IFRS 1 *First-time Adoption of International Financial Reporting Standards.*

3. The two requests received identify a situation where an entity has previously capitalised costs, but changes its accounting policy for these costs upon adoption of IFRS 1. The requests (which are related to each other) ask whether retrospective adjustment is needed to assets recorded in accordance with previous GAAP, to reflect the revised costs that are eligible for capitalisation in accordance with an entity's chosen IFRS accounting policy.

4. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the issue within the context of IFRSs;

   (c) provides preliminary agenda criteria assessment;

   (d) makes a staff recommendation on the tentative agenda decision; and

   (e) asks the IFRIC whether they agree with the staff recommendation.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

Background information

5. In October and December 2009, the IFRIC received requests identifying an entity that capitalised costs as part of self-constructed assets in accordance with its previous GAAP accounting policy. This previous GAAP accounting policy is also compliant with IFRSs.

6. However, on transition to IFRSs, the entity elects to change this accounting policy. If this chosen IFRS accounting policy had been applied to the costs incurred in constructing these assets, the amount of capitalised costs would have been different.

7. The requests focus on a change in accounting policy relating to actuarial gains and losses of defined benefit plans. It notes that a number of entities change their accounting policy for actuarial gains and losses upon application of IFRS 1, even though their previous GAAP accounting policy is compliant with IFRSs.

8. In applying IFRS 1, these entities may change from a previous GAAP 'corridor' approach, consistent with paragraph 92 of IAS 19 *Employee Benefits,* where **some** of the actuarial gains and losses are recognised in **profit or loss**, to a method of recognising **all** actuarial gains and losses in the period in which they occur through other comprehensive income **(OCI)** in accordance with paragraph 93A of IAS 19.

9. In accordance with its previous GAAP accounting policy and application of the corridor approach, the entity capitalised within self-constructed assets, as a component of labour costs, some of these actuarial gains and losses that would otherwise be recognised in profit or loss.

10. Capitalisation of these costs would also be appropriate under IFRS if the entity applies the corridor approach to accounting for defined benefit plans. This would be consistent with the guidance on costs of conversion in paragraphs 12−14 of IAS 2 *Inventories*, or as contract costs, consistent with the guidance that exists in paragraph 16 of IAS 11 *Construction Contracts*, for example.

11. However, an IFRS preparer that recognises all actuarial gains and losses through OCI would not capitalise any of these costs within inventory or construction contract assets. Consequently on transition to IFRS, actuarial gains and losses are no longer eligible for capitalisation within self-constructed assets in accordance with guidance such as IAS 2 or IAS 11 if the corridor approach is not applied.

12. As a result of this situation, the requests identify two issues:

    (a) **Issue 1** - When an election is made under IFRS 1 to record all unrecognised actuarial gains and losses in equity at transition in accordance with paragraph D10 of IFRS 1, do other assets on the balance sheet at transition (eg inventories recorded under IAS 2 and contract costs recorded under IAS 11) containing a material amount of capitalised actuarial gains and losses require retroactive restatement?

    (b) **Issue 2** - If a retroactive restatement is not required for Issue 1, the issuer identifies a further issue arising from the cumulative approach in IAS 11 to recognising contract expenses in profit or loss. This issue is whether a ‘cumulative catch-up adjustment’ relating to the percentage of completion method of IAS 11 is required, and if so, how it should be accounted for?

Staff analysis

13. In analysing these issues, the staff believe that it is important to consider whether they arise as a result of a:

    (a) change in accounting policy; or

    (b) change in accounting estimates.

Issue 1 – Do assets containing a material amount of capitalised actuarial gains and losses require retrospective restatement?

14. In respect of Issue 1, the requestors identify that upon first-time adoption of IFRSs, entities may change their accounting policy for actuarial gains and losses and apply the IFRS 1 exemption relating to employee benefits.

15. This exemption in paragraph D10 of IFRS 1 states that '*a first-time adopter may elect to recognise all cumulative actuarial gains and losses at the date of transition to IFRSs*'. It provides first-time adopters with practical relief from allocating cumulative actuarial gains and losses between a recognised and unrecognised component from the inception of an employee benefit plan through to the date of transition to IFRSs.

16. However, the requestors question whether the guidance in IFRSs is clear on how actuarial gains and losses capitalised in accordance with previous GAAP, but on a basis that is also in accordance with IFRSs, should be treated at the date of transition to IFRS following this accounting policy change.

***View A** - **No** - assets containing a material amount of capitalised actuarial gains and losses **do not** require retrospective restatement*

17. Proponents of View A argue that retrospective restatement is **not** required for the amount of actuarial gains and losses that were previously capitalised as contract costs or within inventory.

18. They note that on transition to IFRSs, the entity has not changed the IFRS compliant accounting policy for inventory or construction contract assets that it applied under previous GAAP.

19. They consider that the costs previously capitalised reflect **accounting estimates** made by the reporting entity in accordance with previous GAAP, and note that IFRS 1 requires that:

    14 An entity's estimates in accordance with IFRSs at the date of transition to IFRSs *shall be consistent* with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error. (emphasis added)

20. These proponents would argue that if there is no objective evidence that errors were made in determining the capitalisation of actuarial gains and losses under previous GAAP, IFRS 1 prevents a reporting entity from restating these amounts on transition to IFRSs.

21. Proponents of this view consider that this position is supported by:

    (a) recognising that in applying paragraph D10 of IFRS 1, an entity would not be required to restate the amount of employee benefit liabilities, including actuarial gains and losses, recorded in its statement of financial position at the date of transition to IFRSs.

    (b) extending the exemption from retrospective application in paragraph D10 of IFRS 1 that applies to actuarial gains and losses recognised in accordance with IAS 19 *Employee Benefits*, to the components of these costs that are capitalised under other IFRSs.

        They believe that paragraph BC48 of IFRS 1 reflects the Board's intent that preparers should be able to avoid recalculating actuarial gains and losses from the inception of an employee benefit plan to the date of transition to IFRSs because it would be costly and would not benefit users, regardless of whether part of these gains and losses are capitalised.

    (c) guidance in paragraph 38 of IAS 11 which, in applying the percentage of completion method, requires a change in the estimate of contract costs to be recognised in profit or loss in the period in which the change is made and in subsequent periods.

View B* - *Yes *- assets containing a material amount of capitalised actuarial gains and losses* ***do*** *require retrospective restatement*

22. Proponents of View B argue that restatement at the date of transition to IFRSs **is** required for the amount of actuarial gains and losses that were previously capitalised as contract costs or within inventory.

23. They consider that costs previously capitalised reflect the **accounting policy** adopted by the reporting entity prior to adoption of IFRSs and note that the standard is clear in stating that:

> 7 an entity shall use the *same accounting policies* in its opening IFRS statement of financial position and *throughout all periods presented* in its first IFRS financial statements … *except* as specified in paragraphs 13–19 and Appendices B–E. (emphasis added)

24. They point out that none of the exceptions in paragraphs 13─19 or within Appendices B─E of IFRS 1 relate to the measurement of inventory or assets relating to construction contracts, other than the use of an event driven fair value as deemed costs, which is not the case here.

25. As a result, they believe that in accordance with paragraph 11 of IFRS 1, an entity shall recognise adjustments arising as a result of this issue directly into retained earnings at the date of transition to IFRSs.

26. In considering the arguments for View A, these proponents believe that applying the exemption in paragraph D10 of IFRS 1 leads to a change in the accounting policy for actuarial gains and losses, including those costs previously capitalised. They note that paragraph 14 of IFRS 1 requires that *'adjustments to reflect any difference in accounting policies'* should be reflected in estimates **at the date of transition to IFRSs**.

27. They also consider that:

    (a) IFRS 1 includes specific exemptions for similar issues, including components included in the cost of property, plant and equipment and borrowing costs, noting that:

    > D1 An entity shall not apply these exemptions by analogy to other items.

    (b) additional exemptions from retrospective application of accounting policies are inconsistent with the Board's Basis for Conclusions, as highlighted in paragraph BC64 of IFRS 1:

> The Board considered and rejected suggestions for other exemptions. Each such exemption would have moved the IFRS away from a principle-based approach, diminished transparency for users, decreased comparability over time within an entity's first IFRS financial statements and created additional complexity. In the Board's view, any cost savings generated would not have outweighed these disadvantages.

(c) the intent of paragraphs D10 and BC 48 of IFRS 1 are to provide first-time adopters of IFRSs with relief from re-performing actuarial valuations. The accounting adjustment resulting from application of View B would not require re-performance of an actuarial valuation. It would only require a reversal of previously capitalised actuarial gains and losses.

28. The staff agree with View B for the reasons explained above, considering that Issue 1 arises from a change in the accounting policy of an entity on transition to IFRSs. As a result, the staff believe that restatement at the date of transition to IFRSs is required for the amount of actuarial gains and losses that were previously capitalised as contract costs, or within inventory, if such amounts are material.

29. However, the staff do have sympathy for View A, specifically recognising the practical application issues recognised in the IFRS 1 paragraph D10 exemption and BC 48.

Question 1 for the IFRIC
Does the IFRIC agree with the staff's analysis in paragraphs 14-29 and the conclusion that IFRS 1 would require restatement of assets at the date of transition to IFRSs to reflect the entity's accounting policy for actuarial gains and losses?

IFRS 1 amendment considerations

30. If the IFRIC answer yes to Question 1 above, the staff believe that the IFRIC could recommend that the Board should consider an amendment to IFRS 1 to address Issue 1.

31. This amendment could extend the exemption in paragraph D10 of IFRS 1 to those actuarial gains and losses that were previously capitalised in a manner consistent with other IFRSs.

32. However, the staff do not recommend that an amendment should be proposed. This reflects the staff view that:

    (a) entities could **avoid** the issues in the submissions if they **did not elect** to change their accounting policy for the recognition of actuarial gains and losses on transition to IFRSs. This is because IFRS 1 allows an entity to continue to apply a corridor approach to accounting for actuarial gains and losses.

    (b) the submissions focus on the capitalisation of actuarial gains and losses. However, it appears that similar issues could arise following a change in accounting policies on application of IFRS 1, relating to other costs that are eligible for capitalisation. This may include other components of labour cost (eg share-based payment) or additional consideration of the exemption in paragraph D23 of IFRS 1 in relation to borrowing costs.

    (c) an exemption to IFRS 1 for construction contracts due to undue cost and effort considerations was discussed in December 2002 as part of the Board's deliberations on IFRS 1. The staff proposed that this exemption should not be provided, in part because it would conflict with the Board's objective of achieving comparability over time within an entity's IFRS financial statements. The Board agreed with the staff proposals.

Question 2 for the IFRIC
If the IFRIC agrees with Question 1, does the IFRIC agree with the staff's analysis in paragraphs 30-32 not to add an exemption to IFRS 1 addressing this issue?

Issue 2 — If a retrospective restatement is not required for Issue 1, how should the 'cumulative catch-up adjustment' arising under the percentage of completion method of IAS 11 be accounted for?

33. The requestors identify that Issue 2 arises if a conclusion is reached on Issue 1 that either:

    (a) View A is appropriate and consequently retrospective restatement is **not** required for the amount of actuarial gains and losses that were previously capitalised as contract costs in accordance with IAS 11 (either due to interpretation of, or amendment to, current IFRSs); or

    (b) View B is appropriate, but the amount of actuarial gains and losses that were previously capitalised as contract costs is not material at the date of adoption of IFRS 1, but may be material in subsequent reporting periods as these amounts are recognised in profit or loss in accordance with IAS 11.

34. The principle in paragraph 22 of IAS 11 is that contract revenue and contract costs associated with a construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract. This is known as the percentage of completion method and leads to revenue being recognised based upon actual accumulated, and an estimate of total, contract costs.

35. In Issue 2, using the percentage of completion method in accordance with IAS 11 creates a cumulative catch-up adjustment because the change in the estimate of total contract costs will be revised to exclude the amortisation of future actuarial gains and losses.

36. In relation to this issue, the staff identified two alternatives for the recognition of the catch-up adjustment.

37. The first alternative is to recognise the catch-up adjustment directly in **retained earnings** at the date of transition to IFRS. This is consistent with:

    (a) paragraph 11 of IFRS 1 and a view that the cumulative catch-up adjustment results from a **change in accounting policy** as of the date of transition to IFRS.

(b) the treatment of cumulative actuarial gains and losses recognised in accordance with IAS 19 upon application of the exemption in paragraph D10 of IFRS 1.

(c) a practical application view that cost estimations included in recognising contract revenue and expenses under IAS 11 in reporting periods subsequent to the date of transition to IFRS should reflect the reporting entity's post-IFRS transition accounting policies.

38. The second alternative would be to recognise the catch-up adjustment in profit or loss in subsequent reporting periods, either as a one-time adjustment or over the period of the construction contract. This is consistent with:

(a) a view that the cumulative catch-up adjustment results from a **change in accounting estimates**.

(b) paragraph 38 of IAS 11 which, in applying the percentage of completion method, requires a change in the estimate of contract costs to be recognised in profit or loss in the period in which the change is made and in subsequent periods.

39. The staff agree with the requestors that current IFRSs are not clear on how Issue 2 should be addressed.

40. The staff have concerns that the second alternative would result in profit and loss being recognised in periods subsequent to the IFRS transition date that are inconsistent with the IFRS accounting policies of the entity.

41. Consequently, the staff believe the first alternative of recognising the catch-up adjustment directly in **retained earnings** at the date of transition to IFRS is preferable, noting its consistency with the treatment in the D10 exemption in IFRS 1.

42. However the staff also have a concern that, unless an additional exemption is added to IFRS 1, View A of Issue 1 implies that these issues arise from a change in accounting estimate, rather than a change in accounting policy. This seems inconsistent with recording the cumulative catch-up adjustment arising in Issue 2 in retained earnings.

Question 3 for the IFRIC
Does the IFRIC agree with the staff's analysis in paragraphs 33-42 and the staff's view that current IFRSs are not clear on how Issue 2 should be addressed?

Staff recommendation

Agenda criteria assessment for the IFRIC

43. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    No.

    The staff are not aware of the issues being raised by current adopters of IFRSs, either through adoption of IFRS 1 or as a result of a subsequent change in the actuarial gains and losses accounting policy in accordance with IAS 8.

    The staff understand that the issues do have practical relevance in jurisdictions expecting to adopt IFRSs for the first time.

    However, the staff believe that the issues are limited in their relevance to reporting entities that:

    (i) change their accounting policy for actuarial gains and losses on adoption of IFRSs;

    (ii) capitalise a material amount of costs within self-constructed assets (specifically as part of construction contracts or within inventory); and

    (iii) include within the cost of self-constructed assets a material amount of actuarial gains and losses at the date of transition to IFRSs (eg as a result of a significant pension deficit).

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No. The staff believe that current IFRSs are clear and that in the situation presented in Issue 1, restatement is required for the amount of actuarial gains and losses that were previously capitalised as contract costs or within inventory if such amounts are material. The staff believe that current IFRSs are not clear in relation to the situation presented in Issue 2.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes. Financial reporting would be improved through the elimination of diversity in recognising and measuring actuarial gains and losses that are capitalised within self-constructed assets.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Yes. The staff believe that these issues are narrow enough that they could be resolved efficiently within the confines of existing IFRSs and the Framework.

(e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.*

Yes. It is probable that the IFRIC would be able to reach a consensus on these issues on a timely basis.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.*

Not applicable. The IASB does not have any current or planned projects on its agenda that are expected to address these issues.

44. Based on the assessment of the agenda criteria in paragraph 43, the staff recommend that the IFRIC should not add the issue to its agenda. The proposed wording for the tentative agenda decision is set out in Appendix A.

Question 4 for the IFRIC
1. Does the IFRIC agree with the staff's recommendation not to add this issue to its agenda? If not, how does the IFRIC recommend the staff to proceed? 2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision in Appendix A?

[Appendix A has been omitted from this observer note]

Appendix B – Agenda requests

B1. The staff received the following IFRIC agenda requests. All information has been copied without modification by the staff.

Request 1

THE CONTEXT

A large number of entities have significant funded defined benefit pension schemes. Given the recent market crisis, many such pension funds have experienced significant negative returns which have created large unrecognized actuarial losses for entities using the corridor method of accounting for pensions. These rules allow for deferred recognition of actuarial gains and losses.

We are aware that a large number of entities which are adopting IFRS in replacement of their current GAAP intend to record their unrecognized actuarial gains and losses in equity at transition using the IFRS 1 exemption (Appendix D.10). We are also aware that many such entities will change their accounting method for pension costs after transition, from the corridor to the OCI method.

THE ISSUES

The following issues arise in connection with the transition to IFRS when there are significant unrecognized actuarial pension gains and losses at transition:

1. If a change is made at the date of transition to IFRS from the corridor to the OCI method under IAS 19 for actuarial gains and losses **and** an election is made under IFRS 1 to record all unrecognized actuarial gains and losses in equity at transition, do assets on the balance sheet at transition containing a material amount of capitalized actuarial gains and losses (a component of labour costs) require retroactive restatement?

2. If a retroactive restatement is not required for issue 1, how should the so called 'cumulative catch-up adjustment' arising under the percentage of completion method of IAS 11 is accounted for?

The first issue arises mainly in the context of manufacturing companies, as qualifying pension costs (including periodic amortization of actuarial gains and losses under the corridor approach) are often capitalized as a cost of manufactured inventories. However, non-manufacturing entities could also be impacted as it is common to capitalize pension costs as a component of the cost of self-constructed assets (including capitalized development expenditures, property plant and equipment and intangible assets).

The second issue arises only if a retroactive restatement of the balance sheet items at transition to exclude capitalized actuarial gains and losses is not required and an entity applies the 'cost-to- cost' method referred to in IAS 11.30 sub a to determine the stage of completion. As a result of the IFRS 1 election, the estimated costs to complete long-term contracts will be adjusted to exclude the amortization of unrecognised actuarial gains and losses. This change in cost estimates should also impact the percentage of completion of the contract at transition. The mechanical application of long-term contract accounting will give rise to a cumulative catch-up adjustment arising from increases/decreases in the profitability of outstanding contracts at the transition date (see the numerical example attached to this memo).

Analysis

A. Question 1

Under the corridor method, the periodic amortization of actuarial gains and losses was included in the costs of qualifying assets. Using the IFRS 1, D.10 exemption and the OCI method under IAS 19, all unamortized actuarial gains and losses at the transition date will be charged to retained earnings and future actuarial gains and losses will be recognized immediately in other comprehensive income, as permitted by IAS 19. Under this method, actuarial gains and losses do not form part of the cost of self-constructed assets.

IFRS 1 requires retroactive restatement of all balance sheet amounts at the transition date as if IFRS principles and company policies had been historically applied. While exceptions to this full retroactive approach are provided in IFRS 1, these exceptions do not extend to other balances such as the IAS 2 and IAS 11 balances. The IFRS 1 pension exemption does not apply in these circumstances as it would not be necessary to re-determine any actuarial pension amounts for prior periods. The cost component that would have to be excluded from the cost base of the assets should be already available, determined under the previous accounting policies.

IFRS 1, paragraph BC48 sheds some light on the rationale for the employee benefits exemption. It states the following:

> *If an entity elects to use the 'corridor' approach in IAS 19 Employee Benefits, full retrospective application of IAS 19 would require the entity to determine actuarial gains or losses for each year since the inception of the plan in order to determine the net cumulative unrecognised gains or losses at the date of transition to IFRSs. The Board concluded that this would not benefit users and would be costly. Therefore, the IFRS permits a first-time adopter to recognise all actuarial gains or losses up to the date of transition to IFRSs, even if its accounting policy in accordance with IAS 19 involves leaving some later actuarial gains and losses unrecognised (paragraph D10 of the IFRS).*

Therefore, IFRS permits a first time adopter to recognise in equity all actuarial gains and losses up to the date of transition to IFRS (no retroactive restatement), even if its accounting policy in accordance with IAS 19 involves leaving some later actuarial gains and losses unrecognised. Although this exemption is provided in the context of an entity not using the corridor approach before transition, the exemption is not limited in its scope to this situation. It is rather an unqualified exemption available to all entities adopting IFRS for the first time. Also, the reference in BC48 to the inconsistency between recognising all actuarial gains and losses at transition and leaving some of these gains and losses unrecognised subsequent to transition is a clear indication that the IFRS 1 election at transition is independent from subsequent choices of accounting policies.

A restatement of balances containing the amortization of pension cost components would require considerable effort in retroactively computing the new balances, in particular for IAS 11 balances, while the IFRS 1 pension exemption was introduced partly to avoid the impact of a re-computation of balances for practical considerations. Although the re-computation of past pension costs is not required in this case, it could be argued that an exemption from the re-computation of IAS 11 balances should also be provided on practical grounds. These assets do not comprise accumulated costs that would not otherwise be acceptable under IFRS, since the corridor method is an acceptable method under IFRS. In addition, computing IAS 11 balances requires many judgments and estimates that could be tainted by hindsight in recomputinig the amounts at the time of transition to IFRS. The costs of recomputation could be large for entities with many contracts extending back several years. Finally, any overstatement of assets at transition would be properly addressed through an impairment test. Therefore we submit that the scope of IFRS 1 should be extended to provide an exemption for such situations.

B. Question 2

If there is no requirement to restate retroactively balances containing capitalised pension costs (to exclude the amortisation of actuarial gains and losses) or if such requirement is removed through an amendment of the scope of IFRS 1, a related issue arises in connection with long-term contract accounting under the percentage of completion method of IAS 11. As illustrated in the attached example, a cumulative catch-up adjustment arises from the change in estimated costs to complete the contracts since actuarial gains and losses will be excluded from contract costs after transition. The issue is whether this adjustment should be accounted for in retained earnings at transition or recorded in earnings subsequent to transition. The answer to this question depends on the determination of the nature of the adjustment. If the cumulative catch-up adjustment arises from a revision of estimates, the adjustment would be recorded prospectively, i.e. after the opening balance sheet date. If the adjustment arises as a result of an accounting policy choice made under IFRS 1, the adjustment would be recorded in retained earnings at transition.

a. Alternative view 1

The change arises from a decision under IFRS 1, which is an accounting policy choice. Therefore, the proper accounting treatment consists in recording the adjustment to retained earnings on transition. The drawback with this view is its apparent inconsistency with the accounting treatment for other inventory and self-constructed assets (see the last column of the attached numerical example). However, the carrying values of inventories and other assets that exist at transition are unaffected by estimates of future costs to complete. This is not the case for IAS 11 balances that are affected by estimated amounts of future contract costs. It could also be argued that this adjustment must be reflected in the opening balance sheet as it pertains to the adoption of IFRS. Since there is no income statement items at the opening date, there is no option other than to record the adjustment to retained earnings.

Even if a retroactive restatement is not required under IFRS 1, it could also be argued that the cumulative catch-up adjustment arising under the percentage of completion rules of IAS 11 must be recorded to retained earnings on transition to IFRS as it arises from a global change in GAAP, being the adoption of IFRS.

Finally, paragraph 14 of IFRS 1 states the following:

> *An entity's estimates in accordance with IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.*

Paragraph 14 appears to lead to the view that this change does not arise from a change in estimates, as such change would not be allowed unless it arises from an accounting policy change or as a correction of error. Assuming the impact of the change is significant, it would be difficult to argue that the change is the result of a change in estimate and yet the estimate is made on a basis consistent with the estimate made before transition.

b. Alternative view 2

The change is a change of estimate (prospective application), as it results in a revision of the estimated costs to complete the contract. Consistent with any revision of accounting estimates for contracts within the scope of IAS11, such change should be recorded to income as a cumulative adjustment to previously recognized results. This view would align the accounting for long term contract inventory to the accounting for other assets as the impact of the elimination of future actuarial gain and loss amortization from earnings and asset costs will be fully reflected in income after transition (not partially in equity). Under this view, the adjustment should be recorded in profit and losses, either:

- As a one time adjustment in accordance with the percentage of completion rules of IAS 11. However, such adjustment is counter-intuitive as it arises in connection with the transition to IFRS.
- Ratably over the period of change in estimate and subsequent periods. Although this method is not allowed in normal circumstances under IAS 11, it has the benefit of aligning the earnings impact for inventory accounted for under IAS 11 to that of inventory accounted for under IAS 2. For instance, for IAS 2 inventories, the full benefit of lower pension costs after transition will be recognized in income at the time of revenue recognition (i.e. delivery of the underlying product). Under IAS 11, revenues are recognized over the period to completion. Using the revenue recognition rules as an analogy, a recognition method of the impact of the change over the period of change in estimate and subsequent periods could be supported for IAS 11 balances.

REASONS FOR THE IFRIC TO ADDRESS THESE ISSUES

A. Are these issues widespread and practical?

These issues arise for first time adopters of IFRS which elect to apply the OCI method to actuarial gains and losses under IAS 19 in replacement to the corridor method. We believe these issues have the potential of widespread application for entities that have significant unrecognized actuarial pension gains and losses (many large North-American corporations) and also a policy of capitalizing pension costs in inventories or self-constructed assets (most manufacturing entities and other entities with self-constructed assets in North-America). To our knowledge, this fact pattern applies to many entities.

B. Do these issues involve significantly divergent interpretations (either emerging or already existing in practice)?

Based on discussions with peers and with a large international auditing firm, we believe that these issues have already received divergent interpretations and such diversity will continue in the future unless addressed by the IFRIC.

C. Would financial reporting be improved through the elimination of diversity?

These issues have the potential of significantly distorting the comparability of financial statements between a large number of reporting issuers.

D. Are these issues sufficiently narrow in scope?

These issues are limited to the interpretation of the interrelation of the basic accounting rule for accounting changes, which require all changes of accounting principles to be applied retrospectively, and the application of a narrow exemption under IFRS 1 for actuarial pension gains and losses. They also cover a narrow application of the IAS 11 rules in specific circumstances.

E. If these issues relate to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?

To our knowledge, there is no IASB project that would address these issues in the current IASB agenda.

Request 2

December 10, 2009

Potential IFRIC Agenda Item: Actuarial Gains and Losses on Transition to IFRSs

I understand that you have received a proposal that the IFRIC consider issues arising in connection with the transition to IFRSs when there are significant unrecognised actuarial gains and losses at transition. In particular, the proposal raises issues arising when an entity elects to record all unrecognised actuarial gains and losses in equity at transition under the IFRS 1 exemption and elects to change its accounting policy from a method similar to the corridor method under IAS 19 to recording all actuarial gains and losses after transition in equity. The proposal requests interpretation of the following questions:

1. Do assets on the balance sheet at transition containing a material amount of capitalised actuarial gains and losses (a component of labour costs) require retrospective restatement?

2. If retrospective restatement is not required for issue 1, how should the entity account for the "cumulative catch-up adjustment" arising under the percentage of completion method of IAS 11 *Construction Contracts*?

On November 25th, the XXX discussed this proposal.

Regarding the first question, many members of the XXX indicated that there seems to be sufficient guidance in IFRSs to reach the conclusion that retroactive restatement is not required in the circumstances stated in the submissions.

However, regarding the second question, XXX members recommended that IFRIC address the accounting treatment of the cumulative catch-up adjustment. In particular, XXX members noted that the application of IFRSs in these circumstances is unclear and therefore an interpretation would improve the quality of financial reporting. More specifically, it was thought that under IFRSs the fact pattern described in the submission could be interpreted as: (i) a revision of an estimate, requiring prospective treatment and recognition of the adjustment in profit and loss; or (ii) an accounting policy choice, requiring recognition in equity at the time of the change in accounting policy.

XXX members understand that the issue is likely to be widespread, think that there is a risk of significantly divergent interpretations, that addressing this issue would improve financial reporting and that the issue is sufficiently narrow in scope for the IFRIC to address. Furthermore, we know of no current IASB project that would address this issue.