STAFF PAPER

17 January – 18 January 2012

IFRS Interpretations Committee Meeting

[this box can be used to give additional meeting dates]

Project	**IFRS Interpretations Committee Work In Progress**		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Objective of this paper

1. The objective of this paper is to update the IFRS Interpretations Committee (the Committee) on the current status of issues that are in progress but not to be discussed by the Committee in the January 2012 meeting.

2. The following submissions have been received by the staff and will be discussed at a future meeting:

Ref.	Topic	Brief description	Progress
IAS 16-5	*Property, Plant and Equipment:* Contingent pricing of PPE and intangible assets	Request for clarification on how to account for contingent pricing for the outright purchase of a single item of property, plant and equipment (PPE) or an intangible asset. The issue includes: (i) when to record the liability for such contingent prices; and (ii) whether subsequent changes to the contingent price, when recognised, should be recognised in profit or loss or as an adjustment to the cost of the asset purchased.	The Committee decided in its May 2011 meeting to defer further work on this project until the Board concludes its discussions on the accounting for the liability for variable payments as part of the leases project.

IAS 39-26	*Financial Instruments: Recognition and Measurement:* Embedded derivatives	Request for clarification on whether a feature, in a host debt instrument with a fixed interest rate, that gives the holder the option to extend the original term of the instrument results in an embedded derivative that would require bifurcation	We plan to present this issue (Appendix A) to the Committee for the first time at the March 2012 meeting.
IAS 12-14	*Income Taxes*: Accounting for royalty payments claimed as an allowance against income tax payable*:*	Request for clarification on how production based royalties paid to one level of government that can be claimed as an allowance against an income tax payable to another level of government should be classified – as a production cost, or as an income tax?	We plan to present this issue (Appendix B) to the Committee for the first time at the March 2012 meeting.

3. This paper does not include requests on issues that are still at a preliminary research stage, including where further information is being sought from the submitter, or other parties, to define more clearly the issue.

Question

Does the Committee have any questions or comments on the Committee Outstanding Issues List?

Appendix A – Financial Instruments: Recognition and Measurement: Embedded derivatives

Suggested agenda item: Separation of term-extending options in a host debt instrument according to International Accounting Standard 39 *Financial Instruments−Recognition and Measurement* ("IAS 39") or International Financial Reporting Standard 9 *Financial Instruments*.

It has come to our attention that diversity exists in practice in the application of IAS 39 to certain types of term-extending options embedded in fixed-rate debt instruments. Entities commonly issue debt with an embedded option that permits one of the parties to unilaterally extend the maturity date, for instance, by a set term or series of set terms (e.g., one year). In many situations, if the option is exercised, the other terms of the debt, such as the interest rate, remain the same as before the option was exercised. In other words, upon exercise of the term-extending option the interest rate does not reset to a rate equivalent to the then-current market interest rate for debt obligations of similar credit quality. Note that in these situations the debt does not contain any other terms which could result, in a non-default situation, in the investor not recovering substantially all of its recognised investment absent the term extension option. That is, the term extension option is not used to circumvent the guidance regarding situations in which the contractual terms may result in the investor not recovering substantially all of its recognised investment.

Some entities account for these types of embedded term-extending options as derivatives separately from the debt hosts as they are considered not closely related to the debt host contract, while others view the option as an embedded loan commitment that is not accounted for separately. This diversity in the accounting is the result of differing views in practice of whether entities are permitted to analogise to, or are required to apply, the scope exception for loan commitments in IAS 39 or IFRS 9 when they evaluate whether a separate instrument that has the same terms as the embedded term-extending option would meet the definition of a derivative.[1] For further details about the issue, including an analysis of the views encountered in practice, please see Appendix A.

Note that while this issue is written in the context of the debt issuer a similar issue may exist for the debt holder applying the guidance within IAS 39[2].

It would be beneficial for preparers, auditors and users of financial statements if the IFRS Interpretations Committee provided guidance on this issue particularly since the practice of writing these types of term-extending options is prevalent and the difference in accounting treatment and resulting impact on entities' financial statements can be significant. We have provided an analysis of the due process criteria for adding an item to the Committee's agenda in Appendix B.

Yours sincerely,

[Submitter]

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[1] IAS 39:11 (and IFRS 9:4.3.3) lists three criteria that, if all were met, would require an entity to account for an embedded derivative separately from its host contract. One of these criteria is that the embedded derivative, if evaluated as a freestanding item, would be a derivative as defined in the Standard.

[2] Note that the same issue does not exist for the debt holder applying IFRS 9 as that guidance does not require or permit bifurcation of embedded derivatives from financial assets. Further, the term extension option, if it meets specified criteria within IFRS 9, does not preclude the entire instrument from being measured at amortised cost

APPENDIX AA

Subject

Separation of term-extending options in a host debt instrument in accordance with International Accounting Standard 39 *Financial Instruments−Recognition and Measurement* (“IAS 39”) or International Financial Reporting Standard 9 *Financial Instruments* (“IFRS 9”)

Example

On 31 December 2011 Entity A issues $100 million of five percent per annum debt with an original two-year maturity of 31 December 2013. Interest is due monthly and the $100 million principal amount is due at maturity. At its sole option, Entity A may extend the maturity date by up to three one-year terms (the “Term-Extending Options”), with a maximum maturity of 31 December 2016. If Entity A exercises a Term Extension Option, the interest rate on the debt will remain the same five percent as at issuance; in other words, the interest rate does not reset to the then-current market rate of interest. The interest rate at issuance is a market rate that considers the effect of the Term-Extending Options. Other than the term extension option, there are no other terms that affect the amount or timing of the contractual cash flows.

Entity A measures the debt at amortised cost in accordance with IAS 39.[3]

Entity A must evaluate IAS 39 to determine whether the Term-Extending Options qualify as embedded derivatives that require separate accounting from the debt host.[4]

Accounting Question

Must all term extension options be considered embedded derivatives requiring bifurcation by the debt issuer (and by the debt holder under IAS 39 if the entire instrument is not accounted for at fair value through profit or loss) or could, or must, specific types of options to extend the maturity of debt be regarded as loan commitments when evaluating whether the scope exceptions for loan commitments (IAS 39:2(h) and 4) apply?

View A – All term extension options are embedded derivatives.

An option to extend the maturity of debt is different from a loan commitment in important aspects. For example, in the case of term-extending options the debt is already outstanding and no more cash will be advanced upon exercise of the option, whereas in

[3] The issue of this submission would equally apply if Entity A measured the debt at amortised cost in accordance with IFRS 9 *Financial Instruments* if Entity A had adopted it early; however, for purpose of this example, Entity A applies IAS 39.

[4] Note that the following accounting questions focus on the Term-Extending Options described in the example. An analysis of other embedded features, including an analysis of other types of options to extend the term of a debt instrument, is not in the scope of this analysis.

the case of loan commitments, the debt has not been issued yet and cash will be advanced upon exercise of the loan commitment. Additionally, the fee for a term-extending option (the option's premium) is typically included in the interest rate of the debt in which the option is embedded, and thus absent a default by the borrower, the lender will collect that fee when the borrower makes the interest payments (alternatively, the fee may be included in the loans proceeds and thus collected by the lender upfront). On the other hand, if a borrower does not go through with a loan commitment, the lender typically will never collect its commitment fee.

Proponents of View A further note that in developing IAS 39, the IASB did not intend for entities to be able to avoid bifurcation of non-closely related term-extending options by applying the scope exceptions for certain loan commitments in IAS 39:2(h) and 4. They believe that, if the IASB had intended for entities to be able to apply the guidance for loan commitments to term-extending options, it would have stated so (e.g., by specifying that the term loan commitment as used in paragraphs 2(h) and 4 of IAS 39 encompasses term-extending options). As support for their argument, proponents of View A further note that IAS 39 and IFRS 9 provide specific guidance about how to apply the closely-related criterion to term-extending options, and this guidance would be less relevant if entities could apply the scope exceptions in IAS 39:2(h) and 4.

View B – Term extension options may be loan commitments and not embedded derivatives requiring bifurcation.

Supporters of View B acknowledge that term-extending options embedded in debt instruments are different in some aspects to loan commitments; however, they believe specific-types of term-extending options are sufficiently similar to loan commitments for purpose of evaluating the scope exceptions for loan commitments in IAS 39:2(h) and 4.

The Term-Extending Options in the example provide Entity A (the borrower) with the unilateral right to exchange the existing debt with new debt that has the same (fixed) interest rate and principal amount as the existing debt. Similarly, a (typical) loan commitment provides a borrower with the right to obtain a (new) loan from a lender at some defined point or range of time in the future. Under the offered terms, while the lender is contractually obligated to issue the loan to the borrower, the borrower is not required to draw down at the interest rate specified in the term extending option, or even borrow from that lender altogether. Proponents of this view note that the two parties could have achieved the same economics by structuring the transaction as a term loan with a separate loan commitment. Proponents of this view believe that the accounting for similar economics should be accounted for consistently irrespective whether the arrangement is one or two contractual arrangements.

Although the question is in the context of specifically applying the criterion in IAS 39:11(b), supporters of View B note that the economics of debt with a two-year maturity and three one-year fixed-rate term extending options (i.e., the debt in the example) is also substantially similar to debt with a five-year maturity and a par call options at years two, three and four, and that these types of call options would likely be considered closely related to the debt host in accordance with IAS 39:AG30(g).

View C

Either View A or View B is acceptable. Entity A must select one of the views as an accounting policy and apply it consistently to all embedded term-extending options that are similar to the Term-Extending Options in the example.

Separate Note

The guidance in U.S. GAAP on evaluating term-extending options in debt instruments for accounting as derivatives separately from the debt host is very similar to the guidance in IAS 39 and IFRS 9 on this topic.[5]

Furthermore, U.S. GAAP has a similar scope exception for loan commitments as IAS 39.[6] We note that View B for Accounting Questions 1 and 2 is consistent with how U.S. GAAP is applied in practice in this area.

APPENDIX AB

Assessment of the IFRS Interpretations Committee Agenda Criteria

Paragraph 24 of the *IFRS Interpretations Committee Handbook* identifies the necessary criteria that the IFRIC uses to assess whether it should add an item to its agenda. Such criteria are indicated below in italics, with an assessment of how this topic would, or would not, be met for that individual criterion directly below. The *IFRS Interpretations Committee Handbook* does not require that all criteria be met in order for a proposed topic to be added to the agenda.

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

This criterion is met. Fixed-rate debt providing the borrower with an option to extend the maturity is common practice (e.g., in large commercial real estate borrowings).

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

This criterion is met. As discussed in Appendix A, different views exist in practice on the relevance of the scope exceptions in IAS 39 (which will continue to apply when IFRS 9 is effective) for the evaluation of embedded derivatives for separate accounting and on the economic similarity between loan commitments and specific types of term-extending options, such as those that are the subject of this submission. As a result, some account for these types of options separately from the debt in which they are embedded, while others do not.

[5] See Accounting Standards Codification (ASC) 815-15-25-1 and 815-15-25-44.
[6] See ASC 815-10-15-69 to 71.

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

This criterion is met. Two entities that have identical contractual rights (i.e., rights to extend the maturity of existing debt at the same fixed rate), and thus are in an identical position economically, could account for those rights differently because they have applied IAS 39:11 (or IFRS 9:4.3.3) differently.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRS Interpretations Committee and its constituents to undertake the due process associated with an Interpretation.*

This criterion is met. The issues that are the subject of this submission stem from the perceived lack of clarity on whether the scope provisions in IAS 39:2-7 must be considered when applying the embedded derivative guidance in IAS 39:1, and on whether specific types of options to extend the maturity of debt can, or must, be regarded as loan commitments when assessing whether the scope exceptions for loan commitments (IAS 39:2(h) and 4) apply.

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

This criterion is met. The issue is narrow and the fact pattern specific; therefore, the IFRS Interpretations Committee should be able to reach a consensus 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 IFRS Interpretations Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRS Interpretations Committee requires completing its due process.*

This criterion is met. It is unclear whether the IASB will address the scope of IAS 39 as part of the financial instruments project. Further, this issue is relevant both under IAS 39 and IFRS 9. When the IASB incorporated embedded derivative guidance in IFRS 9, it did not address the issue. The IASB appears to have no plans to revisit the topic of embedded derivatives as part of the financial instruments project. Even if the IASB were to decide to address the scope of IAS 39, there is still an issue of whether a term extension option should be considered similar to a loan commitment when applying either IAS 39 or IFRS 9.

Appendix B – Accounting for royalty payments claimed as an allowance against income tax payable

The staff received the following request from the **Australian Accounting Standards Board** (AASB). All information has been copied without modification.

22 December 2011

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Wayne,

IFRS IC potential agenda item request: Accounting for royalty payments claimed as an allowance against income tax payable

We wish to submit a potential agenda item for consideration by the IFRS Interpretations Committee (the "Committee") relating to the accounting for royalty payments made to one level of government claimed as an allowance (i.e. the full amount is creditable) against income tax payable to another level of government.

Although this issue has arisen in Australia in relation to the proposed Minerals Resource Rent Tax (MRRT) and extended Petroleum Resource Rent Tax (PRRT), we believe the issue of how to account for such allowances may also be relevant to other jurisdictions internationally that have, or introduce, tax regimes with the same or similar characteristics. For example, we are aware that some jurisdictions, in endeavouring to direct private sector funding for social programs, have introduced regulations that permit charitable donations to be fully creditable against income tax payable.

In summary, the issue we are requesting the Committee to address is how production based royalties paid to one level of government that can be claimed as an allowance against an income tax payable to another level of government should be classified – as a production cost, or as an income tax? A detailed explanation of the issue, possible alternative accounting treatments and reasons for the Committee to address the issue are outlined in Appendix A to this letter.

If you require further information regarding this proposed agenda item, please contact me or Nikole Gyles (ngyles@aasb.gov.au).

Yours sincerely
Kevin M. Stevenson
Chairman and CEO

Appendix A: Potential agenda item request

Issue

Under the proposed MRRT and extended PRRT in Australia[7], payments made to State Governments for production based royalties are permitted to be claimed as an allowance against MRRT/PRRT payable to the Federal Government (a separate taxation authority). The State Governments have the power to determine the level of royalty to be charged without consultation or approval of the Federal Government.

The allowance for the royalty payments for MRRT/PRRT purposes is grossed up to reflect a 100 per cent credit for the payments made. For example, if an entity has a gross MRRT liability of $10 million, and has already paid $3 million in production based royalties, the net MRRT liability (the amount payable to the Federal Government) would be $7 million ($10m-$3m)[8]. This is designed to avoid double-taxation for affected entities. Any royalties not utilised as allowances in one period are carried forward to future periods and uplifted each year by the Long Term Bond Rate plus a further percentage (5 per cent for PRRT and 7 per cent for MRRT).

On their own, the production based royalties do not meet the definition of income taxes in IAS 12 *Income Taxes.* For the purposes of this request, it should be assumed that MRRT/PRRT are considered to be income taxes within the scope of IAS 12[9].

How should the payments made to State Governments for production based royalties that can be claimed as an allowance against an income tax payable to the Federal Government taxation authority be accounted for?

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[7] The proposed MRRT and extended PRRT passed the House of Representatives on 23 November 2011. It is expected that the legislation will be debated by the Senate in March 2012. The legislation is proposed to be effective from 1 July 2012.

[8] Note that the mechanics of how the MRRT and extended PRRT operate have been simplified for this example. Although the net impact is the same, the mechanics of the MRRT and extended PRRT are that the royalty payments are grossed up as royalty allowances and used to reduce mining profit before calculating any MRRT/PRRT liability. Unused royalty allowances are treated in a similar way to carried forward MRRT losses.

[9] Note that, following the IFRIC rejection notice in March 2006 not to provide guidance on which taxes, in various jurisdictions, are within the scope of IAS 12, the AASB is currently of the view that the proposed Australian MRRT would be an income tax within the scope of IAS 12. In 2007 the AASB issued a domestic interpretation, AASB Interpretation 1003 *Australian Petroleum Resource Rent Tax*. The consensus in AASB Interpretation 1003 is that the Australian PRRT is an income tax within the scope of AASB 112 (the Australian Accounting Standard that incorporates IAS 12). Nonetheless, the classification of the proposed Australian MRRT is not the issue requested to be addressed in this letter – the issue would apply to any tax classified as an income tax within the scope of IAS 12.

Alternative accounting treatments

View 1: Classified as an operating/production cost

The imposition of the royalty is considered to be separate and distinct from the imposition of the MRRT/PRRT, on the basis that the imposts are levied by separate taxation authorities.

The nature of the royalty payments is not changed under the proposed MRRT/PRRT. Accordingly, those supporting view 1 are of the view that royalties should be accounted for as an operating/production cost, as they do not, in themselves, meet the definition of income taxes in IAS 12, and therefore should be included in inventory costing to the extent appropriate. Applying view 1 would result in the current income tax expense arising from MRRT/PRRT being measured as the net amount of MRRT/PRRT payable (i.e. gross MRRT/PRRT payable less royalties paid).

View 2: Classified as an income tax

IAS 12 defines taxable profit (tax loss) as '…the profit (loss) for a period, determined in accordance with the rules established by the **taxation authorities**, upon which income taxes are payable (recoverable)." (paragraph 5, emphasis added)

Under the proposed MRRT and extended PRRT the amounts in the form of a non-income tax paid to one taxation authority are claimed as an allowance against income taxes payable to another taxation authority. This changes the nature of the payments in the form of a non-income tax into payments that are, in substance, an income tax (or prepayment of income tax).

The use of the plural term 'taxation authorities' in the definition of taxable profit means that the distinction between which taxation authority the taxes are payable to is not relevant when calculating income tax payable[10].

Although the nature of the royalty payments, considered in isolation, is not changed under the proposed MRRT/PRRT, the characteristics and substance of the payments in the context of the proposed MRRT/PRRT is changed. Accordingly, those supporting view 2 are of the view that the payment of royalties is considered to be a prepayment of MRRT/PRRT and is presented as a current tax amount following the requirements of IAS 12. Applying view 2 would result in the income tax expense arising from MRRT/PRRT being measured as the total amount of taxes payable under the MRRT/PRRT regime (i.e. net MRRT/PRRT payable plus royalties paid).

To the extent that there is sufficient MRRT/PRRT payable during the year, the royalty payment would be treated as a current tax amount and presented as part of current income tax expense as there would be sufficient MRRT/PRRT payable against which the royalties IFRS IC potential agenda item request: Accounting for royalty payments claimed as an allowance against income tax payable Page 4 of 4

[10] The term *taxation authorities* is not defined in IFRS. The conventional reading of the term implies that the term is not limited in use to only authorities that collect income tax, as defined in IAS 12, but might also include authorities that collect taxes that are not income taxes, e.g. production based taxes.

paid could be claimed as an allowance. To the extent an entity does not have sufficient MRRT/PRRT payable during the year, the prepayment would be an asset at year-end.

Summary

In summary, the difference between the two views is about whether claiming an expense paid to one taxation authority as an allowance against income tax payable to a different taxation authority is viewed as bringing the original amount paid within the scope of IAS 12.

Reasons for IFRS IC to address the issue

Criteria	Assessment
The issue is widespread and has practical relevance.	Yes. The issue affects all entities in Australia subject to the proposed MRRT and extended PRRT. A number of these entities have international operations and IFRS reporting requirements in jurisdictions other than Australia. The issue is also likely to affect entities in other jurisdictions that have introduced similar tax regimes whereby amounts in the form of non income taxes payable to one taxation authority are claimable as an allowance against income taxes payable to another taxation authority.
The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice).	Yes. Based on outreach performed to industry participants and Big 4 accounting firms within Australia the AASB is of the view that, in the absence of further guidance, diversity in practice could arise on the introduction of the new tax regime.
Financial reporting would be improved through the elimination of the diversity.	Yes. The accounting treatment in view 1 would provide a significantly different outcome to view 2 (as illustrated in Appendix B to this letter). Therefore, eliminating or reducing the potentially diverse reporting methods would improve financial reporting.
The issue is a narrow implementation or application issue that can be resolved efficiently within the confines of existing IFRSs and the *Framework for the Preparation and Presentation of Financial Statements,* but not so narrow that it is inefficient to apply the interpretation process.	Yes. The issue relates to an interpretation of a specific application of IAS 12.
If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance on a more timely basis than would be expected from that project.	There is no current IASB project, however, depending on the outcome of the IASB's agenda consultation, the Income Taxes project may be reactivated. There is a pressing need to provide guidance on a more timely basis than would be expected from that project as the proposed MRRT and extended PRRT are expected to be effective from 1 July 2012.