NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

December 2004

The International Financial Reporting Interpretations Committee met in London on 2 and 3 December 2004, when the principal matters it discussed were:

- Service concessions
- IFRS 2: changes in contributions to ESPPs
- Scope of IFRS 2
- IFRS 2: treasury share transactions and group transactions
- Reassessment of embedded derivatives
- Decommissioning, restoration and environmental funds
- IAS 1 *Presentation of Financial Statements* – Matters arising

Service concessions

The IFRIC approved for publication three draft Interpretations on service concession arrangements. The Interpretations were approved subject to a number of amendments agreed at the meeting.

A service concession arrangement is a contractual arrangement for the provision of public services. The contract is between the 'grantor' and the 'operator'. The grantor (typically a public sector entity) conveys to the operator the right and obligation to provide specified services for the period of the concession. The operator's responsibilities may include constructing, financing and/or operating the infrastructure—eg roads, prisons, hospitals, and energy supply networks—used to provide the public services.

Overview of proposals

The draft Interpretations agreed at the meeting apply to service concession arrangements in which:

- the grantor controls the services provided by the operator;
- the grantor controls the residual interest in the infrastructure and that residual interest is significant.

The draft Interpretations set out proposals on how an operator should account for infrastructure that is:

- constructed or acquired by the operator for the purpose of the concession; or
- a pre-existing asset of the grantor, to which the operator is given access for the period of the concession.

The first of the three draft Interpretations proposes that the operator should not recognise the infrastructure as its property, plant and equipment. Rather, it should recognise the rights it receives in exchange for providing construction and other services (or other consideration) to the grantor as:

(a) a financial asset – if the grantor has primary responsibility for paying the operator; or

(b) an intangible asset – in all other circumstances, ie if the users of the concession services pay the operator for them.

The second of the three draft Interpretations sets out proposals on how the financial asset model should be applied.

The third of the draft Interpretations sets out proposals on how the intangible asset model should be applied.

The draft Interpretations do not specify the accounting treatment to be adopted by the grantor.

Amendments to the draft Interpretations discussed at the meeting

The IFRIC approved the draft Interpretations prepared by staff subject to a number of amendments being made by staff. The more significant of these are:

(a) the addition of worked examples to illustrate the application of the financial and intangible asset models. The IFRIC asked the staff to prepare examples for consideration at its next meeting.

(b) the elimination of cross-references in the third Interpretation to requirements proposed in the second Interpretation. The IFRIC members took the view that it would be easier for preparers to apply the intangible asset model if all relevant requirements were contained within a single Interpretation.

(c) a change in the drafting to make it clearer that the only specific transitional provision proposed was an option to reclassify existing concession assets as either financial or intangible assets (depending on the model being applied) without remeasuring them. Other assets and liabilities of the concession operator would not be the subject of specific transitional provisions.

Other decisions taken at the meeting

The IFRIC considered a request for additional guidance on the treatment of infrastructure that was used in part for services regulated by the grantor and in part for unregulated services. It decided not to add the guidance, taking the view that the appropriate accounting treatment would depend on a number of variables, which would have to be considered on a case-by-case basis.

The IFRIC agreed to consider various questions that had arisen during its discussions on service concessions but were of wider relevance, and hence might need to be the subject of Interpretations in their own right. These included:

(continued)

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Service Concessions *(Continued)*

(a) the conditions for recognising a sale arising from sale and leaseback transactions containing a repurchase agreement;

(b) the timing of recognition of obligations to repair or restore assets that are the property, plant and equipment of another entity;

(c) the extent to which borrowing costs attributable to construction contract costs could be capitalised; and

(d) the way in which IAS 11 *Construction Contracts* should be applied when a contract involved several different activities that, whilst not meeting the conditions for segmentation, generate different margins.

Next steps

It is planned that the draft Interpretations on service concessions will be published for comment early in 2005.

IFRS 2: changes in contributions to ESPPs

The IFRIC approved the publication of a draft Interpretation on how to apply IFRS 2 *Share-based Payment* to account for changes in contributions to employee share purchase plans (ESPPs). In particular, the draft Interpretation will address how to apply IFRS 2 when an employee ceases to contribute to an ESPP or changes from one ESPP to another.

The draft Interpretation will propose:

- If an entity's employee, while remaining in the entity's employment, ceases to contribute to an ESPP and, as a consequence, is no longer able to buy shares under the plan, the entity shall account for this event as a cancellation. Therefore, in accordance with paragraph 28(a) of IFRS 2, the entity shall recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.
- If an employee changes from one ESPP to another, the entity shall account for this event in accordance with paragraph 28(c) of IFRS 2. For example, if the entity identifies the equity instruments granted to the employee under the new ESPP as replacements for the equity instruments granted to that employee under the original ESPP, the entity should account for this event as a modification of the original grant of equity instruments.

Subject to clearance by the IASB, the draft Interpretation will be published later this month.

Scope of IFRS 2

The IFRIC continued their discussions of the scope of IFRS 2. At its meeting in November, the IFRIC tentatively agreed to develop a draft Interpretation on the topic. This draft Interpretation would address the issue of whether it is necessary to demonstrate that an entity has received goods and services for an issue of equity instruments to be within the scope of IFRS 2. In particular, the issue is whether, or in what circumstances, IFRS 2 applies to transactions in which an entity has issued equity instruments and the fair value of the identifiable assets received (including cash) appears to be significantly less than the fair value of the equity instruments issued?

The IFRIC considered a preliminary draft of a draft Interpretation. The IFRIC requested the staff to amend the preliminary draft for discussion at its next meeting.

IFRS 2: treasury share transactions and group transactions

The IFRIC continued its discussion of share-based payment arrangements in which:

(a) an entity grants options to its employees and either chooses or is required to purchase its own shares upon exercise of the options by its employees.

(b) a subsidiary's employees are granted rights to shares of the parent.

In the latter situation, the issues relate to applying paragraph 3 of IFRS 2 in the individual or separate financial statements of the subsidiary and its parent.

IFRIC members discussed a series of examples prepared by the staff (for details of the examples, refer to the Observer Notes on the IASB Website). In examples 1 and 2, IFRIC members tentatively agreed with the staff analysis that the arrangements should be classified as equity-settled. In examples 3 and 4, the staff presented two views on the classification of the share-based payment arrangement by the subsidiary. The majority of IFRIC members tentatively agreed that the subsidiary should classify the arrangement as equity-settled (referred to as View A in the Observer Notes).

The IFRIC requested that the staff prepare a preliminary draft of a draft Interpretation on the issues covered in those examples. That preliminary draft will address separately the following situations:

(a) a subsidiary grants to its employees rights over shares of its parent; and

(b) a parent or shareholder grants rights over its shares directly to a subsidiary's employees.

The IFRIC will discuss the preliminary draft at a future meeting.

Reassessment of embedded derivatives

IAS 39 *Financial Instruments: Recognition and Measurement* states that an embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. It requires the separation of such a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(d) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

The IFRIC considered two issues arising from the above requirement in IAS 39:

(a) whether the assessment at initial recognition should be reconsidered throughout the life of the contract; and

(b) whether a first time adopter should undertake the assessment of 'closely related' using the conditions that existed when the contract was first entered into, or those when the entity adopts IFRS for the first time.

The IFRIC tentatively agreed that:

(a) the assessment at initial recognition (whether any embedded derivatives exist and are required to be separated) shall <u>not</u> be reconsidered throughout the life of the contract; and

(b) a first-time adopter shall undertake the assessment of 'closely related' using the conditions that existed when the contract was first entered into and not those when the entity adopts IFRSs for the first time.

The IFRIC also tentatively agreed to proceed to a draft Interpretation that would be considered at a future meeting.

Decommissioning, restoration and environmental funds

The IFRIC agreed to change the effective date of the forthcoming IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* to annual periods beginning on or after 1 January 2006, with earlier adoption encouraged, so that the amendment to IAS 39 incorporated in IFRIC 5 would not disrupt the IASB's stable platform of Standards in force for entities adopting IFRSs for the first time in 2005.

IAS 1 *Presentation of Financial Statements* – Matters arising

The IFRIC considered a report on the IASB's decision in November 2004 on whether it would support the development of an Interpretation on the presentation of expenses in income statements. The IASB had indicated that it would not support an Interpretation that specifies which expenses should be included in particular functional classifications. However, it would support an Interpretation that brings forward the following point from the Basis for Conclusions for IAS 1 *Presentation of Financial Statements*:

> "It would be inappropriate to exclude from the results of operating activities, if disclosed, items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount."

The IFRIC did not favour developing an Interpretation on the latter issue alone. IFRIC members were concerned that such an Interpretation would have a limited effect on financial reporting because:

(a) "the results of operating activities" is not a defined term, and therefore there would remain considerable discretion in determining what may normally be included in that amount, if disclosed;

(b) entities would continue to be permitted to report sub-totals in the income statement for "the results of operating activities before … (particular items)" and then highlight those sub-totals in other reports; and

(c) unless paragraph 89 of IAS 1 were amended to require an analysis either by function or nature to be disclosed on the face of the income statement, inappropriate presentation of expenses in income statements could continue, and any Interpretation developed could be applied only to footnote disclosure.

The IFRIC asked the staff to communicate its analysis to the IASB.

Items not added to the Agenda

The IFRIC ratified decisions reached at the November meeting not to add the following items to the agenda (see the November IFRIC *Update* for more information).

- IAS 2 *Inventories*: Discounts and rebates
- IAS 11 *Construction Contracts* and IAS 18 *Revenue*: Pre-completion contracts for the sale of residential development properties
- IAS 16 *Property, Plant and Equipment* and IAS 17 *Leases*: Depreciation of assets leased under operating leases
- IAS 38 *Intangible Assets*: Subscriber acquisition costs

The IFRIC did not consider any new topics at this meeting.

Future meetings and requests for Interpretations

The IFRIC's meetings for 2005 are expected to take place in London, UK, as follows:

- 3 and 4 February 2005
- 31 March and 1 April 2005
- 2 and 3 June 2005
- 28 and 29 July 2005
- 1 and 2 September 2005
- 3 and 4 November 2005
- 1 and 2 December 2005

Meeting dates, tentative agendas and additional details about the next meeting will also be posted to the IASB Website at www.iasb.org before the meeting. Interested parties may also submit requests for Interpretations through the IASB Website.

