NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB

IFRIC UPDATE

February 2004

The International Financial Reporting Interpretations Committee met in London on 3 and 4 February 2004, when it discussed:

- Draft Interpretation D2 *Decommissioning, Restoration and Similar Liabilities*
- Draft Interpretation D1 *Emission Rights*
- Starting to apply IAS 29
- IAS 19: defined contribution pension plans with a guaranteed minimum return on assets
- IAS 27: investments of venture capital providers
- IAS 32: members' shares in co-operative banks
- IAS 41: recognition and measurement of biological assets
- Service concession arrangements

Decommissioning, restoration and similar liabilities

The IFRIC considered a draft final Interpretation on changes in decommissioning, restoration and similar liabilities and agreed in principle to finalise it, subject to certain drafting points. It requested staff to prepare a pre-ballot draft for consideration.

The IFRIC had already decided in December 2003 that the draft Interpretation D2 *Changes in Decommissioning, Restoration and Similar Liabilities*, published in September 2003, should be revised to require changes in a decommissioning, restoration and similar liability that result from changes in the estimated timing or amount of the outflow of resources embodying economic benefits required to settle the obligation, or a change in the discount rate, to be added to or deducted from the related asset and depreciated prospectively over its useful life, subject to two safeguards:

- material increases in the asset would be grounds for considering whether the asset is impaired, and
- a zero asset floor should be applied so that, if the reduction in the liability exceeds the carrying amount of the asset, the excess is recognised in profit or loss.

The IFRIC agreed that:

- The scope of the Interpretation should be extended to include mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources. These were outside the scope of D2, because its scope was limited to IAS 16, which excludes them. Respondents from the affected industries seemed in any case to have assumed that they would be within the scope. This would not require re-exposure, but staff should check that there is no conflict with ED 6 *Exploration for and Evaluation of Mineral Resources*.
- The cost of new obligations arising from changes of law would be excluded from the scope of the Interpretation.
- There would be no other substantive changes to the Interpretation, but the examples would be amended to clarify certain matters on which guidance had been sought by commentators.
- If the Interpretation can be issued by the end of March, the effective date will be 1 July 2004.

Emission rights

The staff updated the IFRIC on the Board's discussion of this agenda item in December. The main points noted were as follows.

- The Board had considered and agreed to the IFRIC's proposal to amend IAS 38 *Intangible Assets*. The amendment would require an intangible asset that is like a currency and whose fair value is determinable by reference to an active market (eg a tradeable emissions allowance) to be measured at fair value with changes in value recognised in profit or loss.
- In the light of the IFRIC's work on emission rights (and as a result of concerns with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* expressed by some of the Board's partner standard-setters), the Board had concluded that it should accelerate work on its project to replace IAS 20.
- The Board had proposed that, if it decided to withdraw IAS 20, the IFRIC should re-expose its Interpretation at the same time as the Board exposes its proposal to withdraw IAS 20. This would enable the new draft Interpretation to reflect the proposed amendment to IAS 38 as well as the Board's proposed withdrawal of IAS 20.

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IAS 19 *Employee Benefits*: plans that would be defined contribution plans but for the existence of a minimum return guarantee

The IFRIC has been considering how to account for employee benefit plans that guarantee a return on contributions or notional contributions.

The IFRIC considered a ballot draft of a draft Interpretation that stated that such plans are defined benefit plans under IAS 19 *Employee Benefits* and explained how defined benefit accounting should be applied to such plans.

The IFRIC agreed that the variable element liability should be based on only the value of the assets or notional assets at the balance sheet date without any separate consideration of whether the return on the assets exceeded any fixed guaranteed return.

The IFRIC agreed that when the benefits are based on notional assets, the change in value of the assets should be analysed into an expected return and an actuarial gain or loss. The measurement of the variable element liability should reflect the expected return in full and the actuarial gains and losses to the extent that they would be recognised if the entity's accounting policy on actuarial gains and losses applied. The IFRIC agreed to note in the basis for conclusions its reservations about the deferred recognition options in IAS 19 and to explain that, nonetheless, because those options form such a fundamental part of IAS 19, it felt constrained to extend their application to the variable element liability. The IFRIC also agreed to ask in the invitation to comment whether commentators agreed with this approach.

The IFRIC agreed that the example illustrating the consensus should show a straight-line allocation of benefits to periods of service, rather than an allocation based on the benefit formula.

The IFRIC approved the draft Interpretation for publication, with one member voting against.

IAS 27 *Consolidated and Separate Financial Statements*: investments of venture capital providers

The IFRIC was notified that a request had been received from the European Financial Reporting Advisory Group to consider whether and under what conditions IAS 27 *Consolidated and Separate Financial Statements* requires venture capital providers to consolidate investments held by a venture capital fund for which the provider acts as fund manager.

The IFRIC had a brief preliminary discussion, noting that it needed to understand the issue better and asked the staff to work with EFRAG to develop the issue.

Starting to apply IAS 29 *Financial Reporting in Hyperinflationary Economies*

The IFRIC continued its discussion from the December 2003 meeting on how an entity should start applying IAS 29 in the first year it identifies the existence of hyperinflation and considered a draft Interpretation.

The IFRIC voted to publish the draft Interpretation for public comment, subject to the following minor changes:

- Clarification that the restatement approach does not apply (a) if detailed records of the acquisition dates of items of property, plant and equipment are not available or capable of estimation, in which case an entity uses an independent professional assessment of the fair value of the items as the basis for their restatement, or (b) if a general price index is not available for the periods for which the restatement of property, plant and equipment is required, and an entity uses an estimate based, for example, on the movements in the exchange rate between the functional currency and a relatively stable foreign currency ("a hard currency approach").[1]
- Clarification that restatement for the effects of inflation in accordance with IAS 29 for the first time is regarded as a change in circumstances. Reflecting the effects of inflation for the first time requires the entity to restate its figures as if it had always restated its financial statements for the effects of inflation. This treatment is similar to the retrospective application of a change in accounting policy described in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

IAS 32 *Financial Instruments: Disclosure and Presentation*: Members' shares in co-operative banks

The IFRIC discussed whether, in accordance with IAS 32 *Financial Instruments: Disclosure and Presentation*, members' shares in a co-operative bank should be classified as debt or equity.

The IFRIC agreed to take this issue on to its agenda. It tentatively agreed that it would be most constructive to restrict the scope of its discussions to certain types of retail co-operative banks. The IFRIC noted that if demand for a broader discussion of variable-capital entities developed, it would consider whether any analysis developed to address members' shares in co-operative banks should be modified or elaborated.

The IFRIC had invited representatives of co-operative organisations in Europe (the European Association of Co-operative Banks, DGRV [German Association of

[1] With respect to (b), the IFRIC observed that such an estimation technique would be appropriate only if the change in exchange rates were representative of the change in the inflation index.

Co-operatives] and Confédération Nationale du Crédit Mutuel) to attend the meeting to help them understand the features of these shares. An introduction by these representatives set out the issues and their relevance, and described typical features of co-operative shares.

The IFRIC first discussed whether any distinguishing features of shares in co-operative banks, other than a redemption feature, would result in the classification of those shares as liabilities. Members/shareholders of a co-operative bank have most of the rights of ordinary shareholders in other commercial entities, although the member/ shareholder's rights differ in some respects. The IFRIC identified the following distinguishing features, which are typical of many co-operative banks:

- the governing documents of some co-operative banks state that any net assets remaining on liquidation, after payment of the nominal value of the members' shares, will be paid out to a third party such as a charity, other co-operative or municipality, rather than to the members.
- members typically vote on a 'one member/one vote' basis, rather than in relation to the number of shares owned.
- the co-operative may have the right to call for additional capital from existing and recently departed shareholders.

The IFRIC noted that these features were not unique to co-operative member shares, nor were they the only features of co-operative member shares. Rather, they were examples of some of the ways in which co-operative shares differed from the more common features of shares of other commercial entities. The IFRIC concluded that none of the three distinguishing characteristics above, either individually or in combination, would cause the instruments to be classified as liabilities.

The IFRIC discussed the circumstances in which a member/shareholder's right to request redemption does not create an unconditional obligation for the issuer to redeem the shares. The IFRIC tentatively agreed that a redemption right does not create an obligation for the issuer if the redemption is solely at the discretion of the issuer. The IFRIC tentatively agreed that it would provide some examples of where the issuer has or does not have discretion.

In many jurisdictions, prudential regulators impose restrictions on the number of member shares that may be redeemed. The IFRIC discussed the effect that these restrictions might have on the classification of members' shares in a co-operative bank. Although no consensus was reached, the IFRIC asked the IASB staff to explore further the interaction between such restrictions and the classification requirements in IAS 32.

The IFRIC noted that the examples in IAS 32 addressing the presentation of the balance sheet for entities whose shares do not meet the definition of equity in the Standard were not particularly helpful to co-operative banks. The IFRIC asked the staff to explore whether there were other possible presentations.

It was suggested that a co-operative bank's redemption of member shares could be seen as similar to the activity of a corporation that makes a market in its own shares. The redemption provision is designed to provide member/ shareholders with liquidity for shares that would otherwise be difficult to transfer. The IFRIC noted that liquidity facilities were not directly comparable to the position of members' shares in terms of the rights and obligations they entail.

The IFRIC will continue its discussions at a future meeting.

Recognition and measurement of biological assets and agricultural produce in accordance with IAS 41 *Agriculture*

The IFRIC considered a draft Interpretation on the following issues:

- how to determine fair value of a biological asset.
- how to account for a legal or constructive obligation to re-establish a biological asset after harvest.

Determining fair value

In December 2003, the IFRIC agreed to recommend the Board to issue an interpretation with consequential amendments to IAS 41 clarifying that when an entity uses a discounting model it determines the fair value of a biological asset based on the expected cash flows from the whole life cycle of that asset. The risk that the entity would not receive the expected cash flows should be reflected in the discounting (either in the discount rate or as an adjustment to the cash flows).

At this meeting, the IFRIC agreed to recommend to the Board:

- to amend IAS 41 to clarify that fair value of a biological asset is measured having regard to the highest and best use of the asset for which market participants are prepared to pay.
- to amend the fair value hierarchy in IAS 41, so that it reflects the hierarchy in, among others, IAS 39 *Financial Instruments: Recognition and Measurement*.
- to clarify that when fair value is determined by using valuation techniques an entity shall incorporate assumptions that market participants would use on the basis of facts or information known or knowable as of the measurement date unless impracticable.
- to retain the requirement that the recognised value of a biological asset should reflect the asset's present condition and location, that is to say, the asset should be measured at its fair value *less* transport and other costs of getting the asset to the market and *less* other costs to sell.
- conform the terminology in IAS 41 to other Standards.

The IFRIC will at its next meeting consider the necessary [draft] amendments to IAS 41.

Obligation to replant

The IFRIC considered whether an obligation to re-establish a biological asset after harvest affects the fair value of the biological asset. The IFRIC observed that such an obligation is attached to the land and, thus, does not affect the fair value of the biological assets growing on the land.

The IFRIC then discussed the accounting for the obligation to replant after harvest. The IFRIC agreed that harvest (usually) is the triggering event; in other words, if an entity does not harvest, there is no present liability. Therefore, an entity should recognise a liability to replant at harvest only with a corresponding debit to land. When the entity subsequently settles the liability (ie re-establishes the biological asset) it creates a new biological asset, which is recognised with a corresponding credit to land.

Some IFRIC members, however, noted that an entity may have an obligation to replant a biological asset after harvest but the entity will not always have ownership of the new biological asset created by replanting. This could, for example, be the case in some leases of land. The IFRIC agreed that, in such instances, where an entity has an obligation to re-establish a biological asset, whether it has harvested or not, and the entity will not get the benefits from the creation of the new asset, an entity shall account for such an obligation as a decommissioning cost, ie recognise the liability and a corresponding asset, which should be amortised over the expected leasing period of the land.

Service concession arrangements

The objective of this project is to consider the need to clarify, before 2005, how certain aspects of the IASB's standards are to be applied in accounting for service concessions and similar arrangements.

Balance sheet issues

At previous meetings, the IFRIC had made some tentative decisions about the broad issues that needed to be considered further. It had also started to consider the first of those issues: the extent to which the accounting model in IAS 17 *Leases* is relevant, and how that model should be applied. At its February meeting the IFRIC continued those discussions, and also started to consider various income statement issues.

In the context of the lease accounting model, IFRIC discussed:

- the significance of ownership rights in the model;
- whether the build phase should be considered separately from the operational phase;
- the application of the principles set out in Draft Interpretation D3 *Determining whether an Arrangement contains a Lease* to arrangements in which the concession provider grants the concession operator access to concession assets so that the operator can use the assets to provide services to the provider; and
- how the payment criterion set out in D3 ought to be applied to the types of charging structures that often apply in service concession arrangements.

At the next IFRIC meeting, the IFRIC will continue its consideration of the lease accounting model. It will also start considering other balance sheet accounting models.

Income statement issues

On income statement issues, the IFRIC had a preliminary discussion of how the principles of contract accounting might be applied to a (highly simplified) road concession contract in which the concession operator would build, operate and maintain the road, and at the end of the concession refurbish the road and transfer it in "as new" condition to the concession provider, depending on how the contract and the concession operator's resulting assets were characterised.

The IFRIC agreed that, if it was correct for the concession operator to recognise the physical asset of the road as its own asset, the concession operator could not have provided construction services to the concession provider, and so the concession operator could not recognise revenue on the construction of the road. Conversely, if it were correct for the concession operator not to recognise the physical asset of the road as its own asset, this would mean that the concession operator must have provided construction services to the concession provider (or perhaps to have sold the road to the concession provider).

Many service concessions of this type are funded largely by debt, which is repaid over the life of the concession. The burden of finance costs is high in the early years, which creates large losses if they are recognised as expenses in the period in which they occur. Both concession operators and some national standard-setters have argued that recognising such losses on a concession that is expected to be profitable is not representationally faithful, and that (at least in some circumstances) the costs should be related to the concession as a whole.

The methods that have been put forward include the capitalisation of interest expense, or imputation of interest income, if its recovery is in some way assured under the contract or by regulation, or (possibly subject to a similar condition) the use of an interest method of depreciation. The IFRIC noted that all of these methods present difficulties.

The IFRIC will continue its consideration of income statement issues at its next meeting.

Future meetings and requests for Interpretations

The IFRIC's meetings for 2004 are expected to take place in London, UK, as follows:

23 and 24 March 2004

4 and 5 May 2004

3 and 4 June 2004

29 and 30 July 2004

7 and 8 October 2004

2 and 3 December 2004

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.