NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

June 2005

The International Financial Reporting Interpretations Committee met in London on 2 and 3 June 2005, when it discussed:

- IAS 32 - Convertible instruments denominated in a foreign currency
- Emission rights – consideration of an amendment to IAS 38 *Intangible Assets*
- IAS 19 *Employee Benefits* - Priorities
- IAS 19 - Asset Ceiling
- IAS 19 - Distinguishing defined benefit and defined contribution plans
- IFRIC D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* - Measurement options
- IFRIC D11 *Changes in Contributions to Employee Benefit plans* - Report on IASB decision
- IFRIC agenda decisions
- Tabled agenda proposals

IAS 32 - Convertible instruments denominated in a foreign currency

At its meeting in April the IFRIC had concluded that contracts that will be settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency (a currency other than the functional currency of the entity) are liabilities.

At this meeting the IFRIC explored possible amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* that would achieve equity classification for such contracts.

The IFRIC decided to recommend that the Board consider amending IAS 32 so that, for classification purposes only, a fixed amount of foreign currency is considered to be a fixed amount of cash. The IFRIC noted that such an amendment would result in such instruments being classified as equity under IAS 32.

The IFRIC emphasised the urgency of the issue and asked that it be kept updated on progress.

Emission rights – consideration of an amendment to IAS 38

The IFRIC continued its consideration of a draft of a proposed amendment to IAS 38 *Intangible Assets* (the draft amendment was included in the observer note for the meeting available on the IASB's Website www.iasb.org). The objective of the proposed amendment is to require a narrowly specified subset of intangible assets, including emission rights traded in an active market as defined in IAS 38, to be measured after initial recognition at fair value with the gains or losses arising from changes in the fair value recognised in profit or loss. Consequently, the proposed amendment would eliminate the measurement mismatch for assets and liabilities in IFRIC 3 *Emission Rights* and would result in all changes in the assets and liabilities being recognised in profit and loss.

The IFRIC also considered a paper prepared by the staff of the EFRAG[1]. The paper proposed amending IFRSs to permit emission rights to be designated as a hedging instrument. The amendment would enable emission rights to be used as:

‘(a) a cash flow hedging instrument to hedge the exposure to variability in cash flows that is attributable to a highly probable forecast transaction (that causes pollution and gives rise to an obligation to deliver emission rights); and

(b) a fair value hedging instrument to hedge an exposure to changes in fair value of a recognised liability (to transfer emission rights to settle an obligation arising under the emission rights scheme).’

The IFRIC noted that it previously viewed the suggestion to permit cash flow hedge accounting as an extension of its amendment to IAS 38. In other words, the amendment to IAS 38 could address the measurement and reporting mismatches that arise in IFRIC 3, while hedge accounting then could be considered as a means of addressing the mismatches in the timing of the recognition of changes in assets and liabilities. These timing mismatches arise because allowances are typically recognised soon after the start of a period whereas emissions occur over the year. Hence gains and losses on the allowances in the earlier part of the year are greater than those on the corresponding emission liability. Cash flow hedge accounting addresses the resulting timing mismatch because it defers in equity gains and losses that arise on allowances held to settle forecast emission obligations until those obligations are incurred.

However, the staff of the EFRAG had developed their proposal as an alternative to the IAS 38 amendment. EFRAG staff noted that their hedging proposal would address both measurement and timing mismatches in one step. They also noted that their proposal could be implemented

[Continued…]

[1] The EFRAG staff explained that the paper had neither been discussed with the EFRAG Technical Experts Group, nor exposed for public comment, and that it expressed the views and thoughts of the EFRAG staff only.

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Email: iasb@iasb.org
Website: www.iasb.org

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IASB Publications Department, 30 Cannon Street, London EC4M 6XH, United Kingdom.

Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org

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Emission rights – consideration of an amendment to IAS 38 *[…Continued]*

even in the absence of active markets for emission allowances. In contrast, the IAS 38 amendment would be available only if allowances were traded in an active market.

The majority of the IFRIC expressed support for the EFRAG staff's proposal. However, the IFRIC acknowledged that it was difficult to determine how best to proceed with this project until the Board had indicated its views on the possibility of applying hedge accounting in an emission rights scheme. Therefore, the IFRIC asked that the staff consult with the Board as soon as possible to determine whether the Board would accept this approach. The IFRIC also directed the staff to consider further the interaction between the proposed amendment to IAS 38 and the EFRAG staff's proposal. For example, some members thought the IAS 38 amendment might be a prerequisite for introducing hedge accounting or could simplify the EFRAG proposal by eliminating the need for fair value hedge accounting. On the other hand, others were concerned that the IAS 38 amendment could constrain the use of hedge accounting. The IFRIC also noted its preference for mandating a particular treatment rather than allowing entities a choice in accounting for emission rights. Some members, however, expressed doubts over whether hedge accounting could be mandated. Accordingly, the IFRIC suggested that the default accounting for allowances should be fair value through profit or loss if an entity did not apply hedge accounting.

IAS 19 *Employee Benefits* - Priorities

The staff presented a paper that grouped the outstanding IAS 19 issues into three main areas:

Group 1 - Active issues under development

- D9 - plans with a promised return on contributions
- Distinction between defined benefit and defined contribution arrangements
- Impact of a minimum funding requirement on the asset ceiling

Group 2 – Issues pending deliberation

- Pension promises based on performance hurdles
- Issues related to the non-consolidation model and definition of plan assets

Group 3 – Other issues

- Changes to a plan caused by government
- Treatment of employee contributions
- Treatment of death-in-service and other risk benefits

The IFRIC concluded that a more detailed summary of most of the issues in groups 2 and 3 should be presented to the Agenda Committee in order to determine whether these issues should be considered by the IFRIC.

The IFRIC agreed that the issue in respect of the non-consolidation of employee benefit plans was part of a broader question in respect of consolidation. This is related to the issue in respect of employee benefits trusts under IFRS 2 and should be addressed as soon as possible.

The IFRIC also agreed that the staff should seek to progress the issues in group 1 as fast as possible.

IAS 19 - Asset Ceiling

The staff presented a paper proposing that guidance should be developed on whether a statutory minimum funding requirement (MFR) affects the application of the asset ceiling requirements under IAS 19. The paper also addressed a possible inconsistency of wording between IAS 19 and IFRS 3 *Business Combinations* in the treatment of net plan assets.

The IFRIC asked the staff to provide:

- additional information on the various ways in which the MFR could have an impact on the IAS 19 asset in different jurisdictions;
- an analysis of the methodology and assumptions to be used for determining the reduction in employer contributions that may be possible where there is an MFR in place.
- some further clarification of the staff's recommendations

The IFRIC supported the staff proposal that, in circumstances in which a sponsor would receive any surplus assets if a plan was settled, the net plan asset (that would be received after taking into account all the costs associated with the wind-up) satisfied the recognition requirements of IAS 19.58(b)(ii) for refunds.

As regards the interaction with IFRS 3, the IFRIC recommended that the most effective way of dealing with the possible inconsistency with IAS 19 would be to include an amendment to IFRS 3 in the current Business Combinations project.

IAS 19 – Distinguishing defined benefit and defined contribution plans

The staff presented a paper that proposed a basis for distinguishing between defined benefit and defined contribution plans. In particular, the staff proposed that the distinction between a defined benefit and defined contribution plan should be determined with reference to whether the employer has an obligation in respect of future risks attaching to the benefits earned at the balance sheet date if an employee:

- stays in employment
- retains plan membership; and
- stops accruing future benefits in the plan.

The IFRIC discussion focused on how these three conditions would be applied to career average and current salary plans. Staff explained why the third condition would result in career average but not current salary plans being classified as defined benefit.

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The IFRIC noted that the approach suggested by the staff potentially is useful but asked for further clarification in some areas before reaching a decision. Particular attention needed to be given to:

- the interaction with the proposed approach of the requirements in respect of insured plans under IAS 19 paragraphs 39 – 42;
- the treatment of plans with compulsory membership; and
- whether the financing method used for a plan (ie whether it is funded or unfunded) impacted its classification.

Some IFRIC members noted that it would be useful to address, also, the allowance for salary increases that should be made in the measurement of the obligation for salary-related plans that are not final salary plans.

Some IFRIC members objected to the wording used by the staff to describe how the materiality of a defined benefit element of a plan would be evaluated.

The staff will present a separate paper covering these issues at the next meeting.

IFRIC D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* - Measurement Options

The staff presented a paper that analysed some of the difficulties with the fixed/variable approach and explained the staff's view regarding why an approach similar to a deconstruction approach would give a more faithful representation of the nature of the obligation undertaken by the employer for D9 plans.

However, the staff noted that a deconstruction approach applied to the measurement of both the defined benefit obligation and the pension expense would be inconsistent with IAS 19. This approach would require an amendment to the standard.

The staff proposed that recognising the constraints imposed by the current requirements of IAS 19, as a compromise, an approach similar to the deconstruction approach suggested at the previous meeting, combined with a treatment of the pension expense that would be consistent with the standard, might be appropriate.

The IFRIC asked the staff to present to the next meeting a paper that provided a summary and comparison with examples of the three approaches available:

- the fixed/variable approach proposed in D9
- the ideal approach, which may require an amendment to the standard
- the IAS 19 compliant variation of the deconstruction approach

D11 *Changes in Contributions to Employee Benefit plans* – Report on IASB decision

The staff presented the Board's conclusions on the issues that the Board had been asked by the staff to consider in respect of D11. In particular, the staff reported that the Board concluded that vesting conditions are performance conditions or service conditions only and that all cancellations (whether by an employee or the employer) should be treated in the same way. Furthermore, the Board recommended that the IFRIC should consider whether any additional guidance would be required in respect of D11.

The IFRIC agreed that the proposed amendment to IFRS 2 would cover the key issues that D11 aimed to address and, further, that an interpretation on the treatment of cessation of employee contributions to an ESPP would no longer be necessary.

The IFRIC also discussed whether there were other issues raised in D11 that should be addressed in addition to the Board's amendment project. The IFRIC did not identify any such issues.

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IFRIC agenda decisions

The following explanations are provided for information only, and do not represent or change existing IFRS requirements. Interpretations of the IFRIC are determined only after extensive deliberation and due process, including a formal vote by written ballot. IFRIC Interpretations become final only if a majority of the IASB does not object to their issue.

A historical record of these decisions can be found on the IASB Website at http://www.iasb.org/current/ifric_non_agenda.asp:

List A Approved as proposed

IAS 1 Normal operating cycle

IAS 12 Carryforward of unused tax losses and tax credits

IAS 17 Finance subleases of finance leases

IAS 19 Determining the appropriate rate to discount post-employment benefit obligations

IAS 39 Hedge effectiveness tests – vacillations in effectiveness/timing of tests

IAS 39 Impairment of an Equity Security*

(*substance of rejection wording included in main body of the April IFRIC Update)

List B Approved with modified wording

IAS 1 Comparatives for prospectuses

IAS 12 Deferred tax relating to finance leases

List C Deferred

These issues will be reconsidered at the August IFRIC meeting. The issue summary and recommendation are not produced below. They were published in the April 2005 IFRIC *Update.*

IAS 7 Value added tax

IAS 12 Non-amortisable intangible assets

IAS 17 Recognition of operating lease incentives under SIC-15

IAS 39 Accounting for securities sold but not yet purchased (short trading)

List A - Approved as proposed

The following agenda decisions were approved by the IFRIC, as published in the April 2005 IFRIC Update.

IAS 1 Normal operating cycle

The IFRIC considered an issue regarding the classification of current and non-current assets by reference to an entity's normal operating cycle. It was asked whether the guidance in IAS 1.57(a) was applicable only if an entity had a predominant operating cycle. This is particularly relevant to the inventories of conglomerates which, on a narrow reading of the wording, might always have to refer to the twelve-month criterion in IAS 1.57(c), rather than the operating cycle criterion.

The IFRIC decided not to consider the question further because, in its view, it was clear that the wording should be read in both the singular and the plural and that it was the nature of inventories in relation to the operating cycle that was relevant to classification. Furthermore, if inventories of different cycles were held, and it was material to readers' understanding of an entity's financial position, then the general requirement in IAS 1.71 already required disclosure of further information.

IAS 12 Carryforward of unused tax losses and tax credits

The IFRIC considered whether to provide guidance on how to apply the probability criterion for the recognition of deferred tax assets arising from the carryforward of unused tax losses and unused tax credits, and in particular whether the criterion should be applied to the amount of unused tax losses or unused tax credits taken as a whole or to portions of the total amount.

The IFRIC decided not to develop any guidance because, in practice, the criterion is generally applied to portions of the total amount. The IFRIC was not aware of much diversity in practice.

IAS 17 Finance subleases of finance leases

The IFRIC considered a suggestion that IAS 17 needed interpretation when assets obtained under finance leases (eg, from manufacturers) are in turn leased immediately by intermediaries, in finance leases, to end users. This was because there was a possibility of the intermediaries treating the assets as inventory when received from the manufacturer followed by a sale to the end user.

The IFRIC took the view that this issue was covered adequately by IAS 17's guidance for finance leases (both for the intermediary in its capacity as a lessee and a lessor and for the end user as a lessee) and by the derecognition requirements of IAS 39 (paragraphs 39-42) as they apply to the finance lease liabilities of the intermediary. The IFRIC did not agree with the treatment that had been suggested.

IAS 19 Determining the appropriate rate to discount post-employment benefit obligations

The IFRIC considered the following question relating to paragraph 78 of IAS 19. If there is no deep market in high quality corporate bonds in a country, may the discount rate for a post-employment benefit obligation be determined by reference to a synthetically constructed equivalent instead of using the yield on government bonds?

Paragraph 78 of IAS 19 states that:

> 'The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the balance sheet date on high quality corporate bonds. *In countries where there is no deep market in such bonds, the market yields (at the balance sheet date) on government bonds shall be used…*' [Emphasis added]

The IFRIC took the view that paragraph 78 is clear that a synthetically constructed equivalent to a high quality corporate bond by reference to the bond market in another country may not be used to determine the discount rate.

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The IFRIC observed that the reference to 'in a country' could reasonably be read as including high quality corporate bonds that are available in a regional market to which the entity has access, provided that the currency of the regional market and the country were the same (eg the euro). This would not apply if the country currency differed from that of the regional market.

IAS 39 Hedge effectiveness tests – vacillations in effectiveness/timing of tests

The IFRIC considered whether under IAS 39 an entity that designates a hedging instrument in a hedge that fails the retrospective effectiveness test can subsequently redesignate the hedging instrument in a hedge of the same financial asset or liability and obtain hedge accounting for a subsequent period in which the hedge is effective.

The IFRIC noted that the Standard did not preclude redesignation of the hedging instrument in a hedge of the same financial asset or liability in a subsequent period provided the hedge meets the hedge accounting requirements in IAS 39. It concluded that, although having practical relevance, the issue did not involve significantly divergent interpretations. Accordingly, the IFRIC decided not to add the topic to its agenda.

IAS 39 Impairment of an Equity Security

The following item was reported in the April 2005 IFRIC Update without specific wording for rejection. At this meeting, the IFRIC approved the following wording for rejection.

The IFRIC considered whether to develop guidance on how to determine whether under paragraph 61 of IAS 39 (as revised in March 2004) there has been a 'significant or prolonged decline' in the fair value of an equity instrument below its cost in the situation when an impairment loss has previously been recognised for an investment classified as available for sale.

The IFRIC decided not to develop any guidance on this issue. The IFRIC noted that IAS 39 referred to original cost on initial recognition and did not regard a prior impairment as having established a new cost basis. The IFRIC also noted that IAS 39 Implementation Guidance E.4.9 states that further declines in value after an impairment loss is recognised in profit or loss are also recognised in profit or loss. Therefore, for an equity instrument for which a prior impairment loss has been recognised, 'significant' should be evaluated against the original cost at initial recognition and 'prolonged' should be evaluated against the period in which the fair value of the investment has been below original cost at initial recognition.

The IFRIC was of the view that IAS 39 is clear on these points when all of the evidence in the requirements and the implementation guidance of IAS 39 are viewed together.

List B - Approved with modified wording

The IFRIC made substantive changes to the wording of the proposed reasons for rejection of the following issues. The final approved text is below:

IAS 1 Comparatives for prospectuses

The IFRIC considered whether to amend requirements in IAS 1.36 relating to comparative information, because of perceived practical problems in complying with EU requirements for prospectuses.

The IFRIC decided not to take the item onto its agenda because it believed that the issue involved a difference of approach between IAS 1 and certain regulatory requirements that were not capable of being resolved merely by issuing an interpretation of IAS 1.

IAS 12 Deferred tax relating to finance leases

The IFRIC considered the treatment of deferred tax relating to assets and liabilities arising from finance leases.

While noting that there is diversity in practice in applying the requirements of IAS 12 to assets and liabilities arising from finance leases, the IFRIC agreed not to develop any guidance because the issue falls directly within the scope of the Board's short-term convergence project on income taxes with the FASB. An exposure draft is expected later this year.

Tabled agenda proposals

The following items, including where appropriate suggested reasons for not adding them to the IFRIC agenda, will be discussed at the August IFRIC meeting. Care should be exercised in reading each of the suggested wordings, as they are expressed in the form recommended by the IFRIC Agenda Committee, which it would employ if it were the IFRIC. References to the IFRIC deciding are therefore placed in [square brackets], since it will be for the IFRIC to reject or accept that wording at its next meeting.

IAS 11	Classification of contract assets
IAS 37	Obligations to repair/maintain another entity's property, plant and equipment
IAS 38	Regulatory asset
IAS 39	Meaning of delivery - Gold hedging

Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are welcome to relay these concerns by 8 July 2005, preferably by email to:

International Financial Reporting Interpretations Committee

First Floor, 30 Cannon Street, London

EC4M 6XH, United Kingdom

email: ifric@iasb.org

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IAS 11 Classification of contract assets

During its project on service concession arrangements, the IFRIC had reached a conclusion that the 'amount due from customers' asset that arose from the application of IAS 11 *Construction Contracts* is a financial asset within the scope of IAS 32 *Financial Instruments: Disclosure and Presentation*. This asset is not a qualifying asset for the purposes of capitalisation of borrowing costs; interest would be accrued instead on the financial asset.

The IFRIC considered a suggestion that this conclusion should be reflected in a separate Interpretation, as it applied not only to service concession arrangements but also to all transactions accounted for in accordance with IAS 11.

[The IFRIC decided] not to pursue this suggestion. The IFRIC was not aware of any evidence that the conclusion was of major importance outside the service concession sector. The IFRIC will reconsider this decision if the responses to the draft Interpretations on service concession arrangements indicated otherwise.

IAS 37 Obligations to repair/maintain another entity's property, plant and equipment

The IFRIC considered a suggestion made during its project on service concessions that it should take onto its agenda a separate project to interpret the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in respect of obligations to repair or maintain another entity's property, plant and equipment.

[The IFRIC decided] not to add this project to its agenda because, in practice, entities are recognising a provision for repairs as damage occurs. The IFRIC was not aware of any evidence that significantly divergent interpretations were being reached in practice.

IAS 38 Regulatory asset

The IFRIC considered a request for guidance for operations subject to price regulation. The request concerned situations in which a regulatory agreement allowed the entity to increase its prices in future years to recover outflows of economic resources during the current or previous years. The IFRIC was asked to clarify whether a regulatory asset – either deferred costs or an intangible asset in respect of an expectation that the entity will recover these costs as part of the price charged in future periods – should be recognised.

The IFRIC observed that it previously had discussed the recognition of such 'regulatory assets' in the context of service concession arrangements. It had concluded that entities applying IFRSs should recognise only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

The IFRIC had noted that the US SFAS 71 *Accounting for the Effects of Certain Types of Regulation* allowed entities to recognise regulatory assets. However, the IFRIC had concluded that the recognition criteria in SFAS 71 were not fully consistent with recognition criteria in IFRSs. Thus the requirements of SFAS 71 were not indicative of the requirements of IFRSs.

Having concluded that expenses incurred in performing price-regulated activities should be recognised in accordance with applicable IFRSs, [the IFRIC decided] not to add a project on regulatory assets to its agenda.

IAS 39 Meaning of delivery - Gold hedging

The IFRIC considered the application of the 'own purchase, sale or usage requirements' scope exemption in paragraph 5 of IAS 39 where:

- the market design or process imposes a structure or intermediary (eg a gold refiner or an electricity market operator) that prevents the producer from physically delivering its production to the counterparty of the hedge pricing contract; and
- in some cases, physical delivery is to the intermediary for the spot price, even if the producer is protected from spot price risk by a separate contract that effectively sets a fixed price for the producer's production.

The IFRIC noted that 'delivery' for the purposes of the paragraph 5 exemption is not necessarily restricted to the physical delivery of the underlying to a specific customer, as physical delivery is not a condition of the exemption. The IFRIC was of the view that delivery of gold to a refiner in return for an allocation of an equivalent quantity of refined gold was not delivery, but that allocation of that refined gold to a customer's account could be considered delivery. [The IFRIC] decided not to develop guidance on the meaning of 'delivery' as it was not aware of any evidence of significant diversity in practice.

[The IFRIC indicated] that a synthetic arrangement that results from the linking of a non-deliverable contract entered into with a customer to fix the price of a commodity with a transaction to buy or sell through an intermediary would not satisfy the paragraph 5 scope exemption.

Change in meeting dates

The IFRIC meeting scheduled for 28 and 29 July 2005 has now been changed to 1 and 2 August 2005.

Future meetings and requests for Interpretations

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

- 1 and 2 August 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 at www.iasb.org/about/ifric.asp

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