NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB

IFRIC UPDATE

July 2006

IFRIC Update is published as a convenience to the IASB's constituents. All conclusions reported are tentative and may be changed or modified at future IFRIC meetings.

Decisions become final only after the IFRIC has taken a formal vote on an Interpretation or Exposure Draft, which is confirmed by the IASB.

The International Financial Reporting Interpretations Committee met in London on 6 and 7 July 2006, when it discussed:

- IAS 18 *Revenue* - Customer Loyalty Programmes
- IFRS 2 *Share Based Payment* - Group and Treasury Share Transactions
- Service Concession Arrangements
- IAS 19 *Employee Benefits* - The effect of a minimum funding requirement on the asset ceiling
- IAS 18 *Revenue* - Guidance on identifying agency arrangements
- IAS 39 *Financial Instruments: Recognition and Measurement* - Securitisations: Derecognition of groups of financial assets
- IFRS 2 *Share-based Payment* - Employee benefit trusts in the individual or separate financial statements of the sponsor
- IAS 11 *Construction Contracts* / IAS 18 *Revenue* - Allocation of profit in unsegmented contracts
- IAS 39 *Financial Instruments: Recognition and Measurement* - Identification of a portion of an exposure eligible for hedge accounting
- Update on Agenda Committee discussions
- IFRIC Agenda Decisions
- Tentative Agenda Decisions

Changes to the Composition of the IFRIC

The Chairman reported that the Trustees had appointed three new members of the IFRIC:

- Sara York Kenny, Principal Accounting Advisor to the International Finance Corporation, World Bank Group;
- Takatsugu Ochi, General Manager of Planning and Administration Department, Financial Resources Management Group, Sumitomo Corporation, Japan;
- Ruth Picker, Senior Partner in the Technical Consulting Group, Global IFRS of Ernst and Young.

He welcomed Mr Ochi, who was attending the meeting, and the other new members and extended the thanks and appreciation of the IASB and the IFRIC to the three members who had retired at the end of their terms, Shunichi Toyoda, Leo van der Tas and Patricia Walters.

The Chairman also welcomed Reinhard Biebel, the nominated observer of the European Commission, and recorded thanks to his predecessor Allister Wilson.

IAS 18 *Revenue* - Customer Loyalty Programmes

At its May 2006 meeting the IFRIC had reached a consensus on how entities should account for award credits (such as points or air miles) granted to customers in customer loyalty programmes. The consensus was that the award credits should be treated as a separate component of the sale in which they were granted. Hence, some of the consideration received for that sale should be allocated to the award credits. The consideration would be recognised as revenue when the customer redeemed the credits for awards or a third party assumed the obligation to deliver the awards.

At this meeting the IFRIC considered a Draft Interpretation based on the consensus reached in May. It decided that:

- the Draft Interpretation should require the amount of revenue allocated to the award credits to be an estimate of the fair value of the consideration received for them (not the cost of providing the awards).
- the Draft Interpretation should state that this amount may be estimated by reference to the relative fair values of each of the components, ie the amount for which each component could be sold separately. The consensus should suggest that one method of estimating the fair value of the award credits could be by reference to the value of the awards for which the credits could be exchanged. However, the consensus should not prescribe a specific measurement method. The Basis for Conclusions should explain that the IFRIC recognised that different measurement methods could be applied to estimate the fair value of the consideration received for the award credits - it was not seeking to preclude any method that could reasonably be applied to achieve the stated measurement objective, so long as a consistent method was applied to each piece of the transaction.
- the Draft Interpretation should state that, if the amount of consideration allocated to the award credits was estimated by reference to the fair

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value of the awards, the nominal value of the awards would be reduced to take into account the proportion of award credits that were expected to be forfeited by customers.

- the Draft Interpretation should include guidance addressing loyalty programmes in which customers were given a choice of different awards.

The IFRIC directed the staff to amend the proposals for revenue recognition to clarify the treatment of consideration allocated to award credits that are never redeemed. The IFRIC also requested a number of drafting changes.

Subject to these changes, the IFRIC agreed the Draft Interpretation for publication for comment.

IFRS 2 *Share-based Payment* - Group and Treasury Share Transactions

The IFRIC continued its deliberations on two situations previously addressed by Draft Interpretation D17 *Group and Treasury Share Transactions*. In the first situation, the parent (or another entity of the same group) directly grants its equity instruments to the employees of a subsidiary. In the second, the subsidiary grants equity instruments of the parent (or another entity of the same group) to its employees.

The IFRIC first considered situations in which the parent (or another entity of the same group) directly grants its equity instruments to the employees of a subsidiary. The IFRIC discussed three alternatives for determining the amount of the cost of the services from the employees to be recognised in the individual financial statements of the subsidiary:

(i) an approach based on the requirements applicable to cash-settled share-based payment transactions;

(ii) a model similar to that used in paragraph 34A of IAS 19 *Employee Benefits*, which addresses participation in a group plan; and

(iii) an approach taking into account the proportion of services received by the individual subsidiary – the amount of the cost of the services would be based on the group cost determined using the equity-settled measurement basis.

While the IFRIC tentatively supported the third approach, some IFRIC members had concerns that the application of this approach in the financial statements of the subsidiary might have consequences on how transactions are accounted for in separate financial statements in general. Other IFRIC members saw merit in this instance in applying the same basis to the consolidated financial statements and to the financial statements of the subsidiary. In their view, the subsidiary, without the involvement of the parent, would not grant equity instruments of the parent to its employees. Accordingly, they believed that it was appropriate to account for the grant of the equity instruments in the financial statements of the subsidiary in the same way as the parent did in its consolidated financial statements.

The IFRIC went on to discuss the second situation, in which the subsidiary grants equity instruments of the parent (or another entity of the same group) to its employees. The IFRIC did not see a simple solution as to whether or not to apply the third approach for determining the cost of the service received. One IFRIC member expressed a concern that the application of the third approach to circumstances in which a subsidiary had the rights to acquire the equity instruments of the parent might result in significant volatility in the profit or loss account of the subsidiary over the period before the equity instruments were delivered to the employees. The member believed that, if this approach was adopted, the rights to acquire parent shares would be accounted for at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* but the cost of the services received would be measured using the fair value of the equity instruments at grant date. The IFRIC observed that it would not be possible to consider all conceivable scenarios arising from the second transaction, eg tax-driven cases. The IFRIC, therefore, tentatively agreed that, in finalising D17, the staff should focus primarily on the first, more common situation, in which the parent (or another entity of the same group) directly grants its shares to the employees of a subsidiary. The IFRIC agreed that the third approach should be developed for that situation.

The IFRIC also reaffirmed an observation in D17 that how shares are acquired does not affect classification of the share-based payment plan as equity settled or cash settled. That classification is based on the terms of the agreement with the employee or other counterparty.

The IFRIC asked the staff to prepare a draft of a revised Interpretation to enable the IFRIC to conclude at its next meeting whether it will be able to reach a final Interpretation.

Service Concession Arrangements

At this meeting the IFRIC discussed the treatment of obligations arising in the operations and maintenance phase of a service concession arrangement, with particular reference to maintenance obligations.

The IFRIC considered amending the example included in D13 *Service Concession Arrangements - The Financial Asset Model* to reflect the types of contractual obligations that exist in practice. The staff proposed that in most cases the maintenance obligations would be accounted for in the same way as proposed in D14 *Service Concession Arrangements - The Intangible Asset Model*.

The IFRIC noted that the operator recognises revenue for providing construction services equal to the fair value of consideration received for that service in accordance with IAS 11 *Construction Contracts*. The consideration received can be a receivable or an intangible asset. Under the proposals in D13 and D14 the nature of the asset recognised as a result of the operator providing construction services dictates the subsequent accounting for the maintenance activities of the arrangement. Respondents to the Draft Interpretations questioned why similar obligations for maintenance would be accounted for differently under the financial and the intangible asset models.

The IFRIC considered the findings of further research conducted by staff. A wide range of arrangements exists for the maintenance activity under a service concession. The terms of the agreement depend on the objectives of the grantor and the operator in negotiating the arrangement, the jurisdiction and the industry sector. In rare circumstances, the maintenance arrangements are on a 'cost plus' basis, as illustrated in the guidance included in D13. That is, the operator is reimbursed for its maintenance costs plus an agreed margin. Each service activity is revenue generating and costs and revenue are recognised in accordance with IAS 11, ie on a percentage of completion basis. More often, as illustrated in the guidance included in D14, the operator is not specifically remunerated for its maintenance activities. Instead all revenue for the operational phase is included in the fee that the operator is allowed to charge for its services or in the payment formula agreed between the grantor and the operator.

Some IFRIC members stated that, while they acknowledged that the example included in D13 would have limited application in practice, they were reluctant to delete it. They believed that the requirement to bifurcate arrangements when the operator is paid for its services partly by a financial asset and partly by an intangible asset would address the matter. Other members stated that the proposed amendment would clarify that the guidance requires an assessment of the substance of the contractual obligations arising during the operations and maintenance phase. Furthermore, the accounting for that phase of the contract was not dependent on the nature of the asset recognised in return for the construction services provided by the operator. The staff proposed that, when the operator is not specifically remunerated for maintenance activities, the guidance illustrated in D14 should be applied.

In September, the IFRIC will consider the text of the Interpretation incorporating all the decisions taken on the project. The examples in D13 and D14 will be revised to illustrate contractual obligations existing in practice.

IAS 19 *Employee Benefits* - The effect of a minimum funding requirement on the asset ceiling

The staff presented a revised Draft Interpretation on the Minimum Funding Requirement and the Asset Ceiling. The draft reflected revisions agreed at the previous meeting, including:

- Clarification of the treatment of the adjustment to the balance sheet asset or liability. The IFRIC agreed that any adjustments to the net balance sheet asset or liability, as a result of a minimum funding requirement, should be recognised immediately.
- Consistency in the demographic assumptions used. The IFRIC agreed that the actuarial assumptions, including demographic assumptions, used in computing the net balance sheet asset should be consistent with the assumptions made to compute the benefit obligation at the balance sheet date.
- Clarification of the transitional provisions. The IFRIC agreed that full retrospective application should be required and no specific transitional requirements would be given in respect of first-time adopters.
- Including a reference to IAS 1 *Presentation of Financial Statements* in the Consensus. The IFRIC agreed that a specific disclosure requirement is unnecessary, as IAS 1 requires an entity to disclose information about the key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amount of the net balance sheet asset or liability.
- Other editorial changes.

At the July meeting, the IFRIC agreed the following:

- to reaffirm the decisions made at previous meetings. In relation to the proposed reference to IAS 1 in the Consensus, the IFRIC asked that it include mention of the types of disclosure that may be relevant under IAS 1. For instance, whether there are any restrictions on the current realisability of the plan assets or the basis used to determine the economic benefit available as a refund (ie whether the plan liability is assumed to be settled gradually or on wind-up or whether refunds are permitted under the plan rules).
- some additional editorial changes.

The IFRIC agreed to publish the revised text as a Draft Interpretation after amendment to reflect the changes agreed at the meeting and subject to negative clearance by the Board.

IAS 18 *Revenue* - Guidance on identifying agency arrangements

The IFRIC discussed whether to take on a project to develop interpretive guidance on how to identify whether an entity was acting as an agent in a selling arrangement and so should recognise revenue net in accordance with IAS 18.

The IFRIC considered that the guidance included in IAS 18 was not sufficiently detailed and that this may be leading to some diversity in practice and agreed to take the issue onto its agenda.

In taking the issue onto its agenda, the IFRIC asked the staff to give the project a lower priority than the other projects which they were currently undertaking.

IAS 39 *Financial Instruments: Recognition and Measurement* - Securitisations: Derecognition of groups of financial assets

The IFRIC continued discussions on two issues relating to the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. The first issue relates to how the derecognition requirements should be applied to transfers of groups of assets. The second issue relates to whether certain transfers of financial assets should be treated as 'pass-through' transactions.

With respect to the first issue, the IFRIC discussed at the May 2006 meeting the possibility that the relevant wording in paragraph 16 of IAS 39 may be inconsistent with the original intention of the Board.

At the July meeting the IFRIC agreed to refer both issues to the Board to clarify their intentions and to ascertain the most effective way to proceed.

IFRS 2 *Share-based Payment* - Employee benefit trusts in the individual or separate financial statements of the sponsor

The IFRIC continued a discussion, begun at its May 2006 meeting, of an issue relating to accounting for an employee benefit trust set up by a sponsoring entity specifically to facilitate the transfer of its equity instruments to its employees under a share-based payment arrangement. The IFRIC discussed whether the employee benefit trust should be treated as an extension of the sponsoring entity, such as a branch, or as a separate entity.

The IFRIC noted that the notion of 'entity' is defined neither in the Framework nor in IAS 27 *Consolidated and Separate Financial Statements*. IFRIC members did not think it appropriate to take onto the IFRIC agenda a project to define an entity or branch, since the Board was currently addressing that issue in its development work on the Framework and on consolidated financial statements. Instead, they preferred to explore how specific transactions between the sponsor and the trust should be treated in the sponsor's separate or individual financial statements and whether transactions between the trust and the sponsor's employees should be attributed to the sponsor.

One member drew an analogy between an employee benefit trust and a share nominee company, which held legal title to the shares registered in its name but acted on those shares only to the order of the beneficial owners. The shares are in the possession of the nominee company but not under its control. A beneficial owner would account in its financial statements for its beneficial holding of shares, not for an investment in the nominee company.

Another issue was what recognition the sponsor should give in its separate or individual financial statements when the employee benefit trust transfers shares to employees.

A third issue was whether in some circumstances a sponsor should be recognising a right or obligation to reacquire its own shares as partial satisfaction of a loan or as a return of its investment.

The IFRIC asked the staff to analyse further the issues discussed during the meeting.

IAS 11 *Construction Contracts* / IAS 18 *Revenue* - Allocation of profit in unsegmented contracts

At its March 2006 meeting, the IFRIC considered an issue identified when deliberating revenue recognition and measurement relating to certain service concession arrangements. The issue concerned whether it was appropriate, in an unsegmented contract, to allocate different profit margins to the different components of a contract. The IFRIC noted that this issue had ramifications beyond service concession arrangements and asked the staff to give priority to a separate project to analyse IAS 11 and IAS 18 to determine whether it is appropriate, in an unsegmented contract, to allocate different profit margins to the different components.

At its July meeting, the IFRIC agreed with the staff that, where a contract provides for construction services and other services not directly related to construction activities, it was appropriate to split the contract into construction (to which IAS 11 segmenting requirements would apply) and other components (to which the IAS 18 requirements for recognising components would apply). The consequence was that different profit margins might be recognised on the different components. The IFRIC also considered this issue in the context of the Customer Loyalty Programmes and Service Concession Arrangements projects. The IFRIC tentatively decided not to take the item onto its agenda but deferred publishing formal wording for this decision, pending the publication of the Draft Interpretation on Customer Loyalty Programmes which will propose relevant guidance on a similar issue.

IAS 39 *Financial Instruments: Recognition and Measurement* - Identification of a portion of an exposure eligible for hedge accounting

The IFRIC has received a number of requests asking whether the risks associated with a specific portion of an exposure might qualify for hedge accounting under IAS 39. For example, the IFRIC has been asked whether inflation risk could qualify as a hedged portion of an interest bearing asset or liability.

At the March 2006 IFRIC meeting, the staff was asked to analyse whether it was possible to identify a principle within IAS 39 that could be used to develop guidance on what qualifies as a hedged portion.

At the July meeting the IFRIC agreed that in IAS 39 the Board, while permitting hedging of some portions of risk for financial assets or liabilities, intended there to be restrictions over what may be designated as a portion in a hedging relationship – that is, a portion cannot be simply anything. The IFRIC also noted that IAS 39 requires a hedged portion to have an effect on the price of the hedged item or transaction that is separately measurable from the hedged item or transaction itself. Consequently, a portion cannot be a residual; that is, an entity is not permitted to designate as a portion the residual fair value or cash flows of a hedged item or transaction if that residual does not have a separately measurable effect on the hedged item or transaction.

The IFRIC also discussed whether a qualifying portion was required to have a predictable effect on the price of the hedged item or transaction (as implied by paragraph AG100 of IAS 39), and if so, what was meant by 'predictable effect'. However, the IFRIC tentatively concluded that the current wording of IAS 39 does not provide a strong enough basis to interpret the meaning of 'predictable effect'.

The IFRIC agreed that the staff should further analyse possible meanings of 'predictable effect' and that, in addition, the issue should be referred to the Board for its views.

Update on Agenda Committee discussions

The staff reported on issues with the Agenda Committee that had not yet reached the IFRIC agenda. Items that had been discussed at the July Agenda Committee meeting were:

- The classification of 'SIM' cards for mobile phones;
- Accounting for catalogues and other marketing costs; and
- The testing of hedge effectiveness on a cumulative basis.

In addition, the following items had been brought to the Agenda Committee at an earlier date but were not yet ready to be presented to the IFRIC, either because they required further staff research or because they were awaiting resolution of a related item:

- Demergers and other 'in specie' distributions;
- Hedging of future cash flows by an option; and
- Hedging a net investment.

IFRIC Agenda Decisions

The following explanations are published for information only and do not change existing IFRS requirements. IFRIC agenda decisions are not Interpretations. *Interpretations of the IFRIC are determined only after extensive deliberation and due process, including a formal vote. IFRIC Interpretations become final only when approved by nine of the fourteen members of the IASB.*

IAS 17 *Leases* - Recognition of contingent rentals

The IFRIC has been asked to consider whether an estimate of contingent rentals payable/receivable under an operating lease should be included in the total lease payments/lease income to be recognised on a straight-line basis over the lease term.

The IFRIC noted that, although the Standard is unclear on this issue, this has not, in general, led to contingent rentals being included in the amount to be recognised on a straight line basis over the lease term. Accordingly, the IFRIC decided not to add this issue to its agenda but to recommend to the Board that IAS 17 be amended to clarify the approach intended by the Standard.

Tentative Agenda Decisions

The IFRIC reviewed the following matters, which the Agenda Committee had recommended should not be taken onto the IFRIC agenda. These tentative decisions, including, where appropriate recommended reasons for not taking them onto the IFRIC agenda, will be re-discussed at the November 2006 IFRIC meeting. Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are welcome to communicate those concerns by 25 September 2006, preferably by email to: ifric@iasb.org or by post to:

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Communications will be placed on the public record unless confidentiality is requested by the writer, supported by good reason, such as commercial confidence.

IFRS 2 *Share-based Payment* - Fair value measurement of post-vesting transfer restrictions

This item is a re-exposure of reasons for rejection first proposed in March 2006 IFRIC Update.

The IFRIC was asked whether the estimated value of shares issued only to employees and subject to post-vesting restrictions could be based on an approach that would look solely or primarily to an actual or synthetic market which consisted only of transactions between an entity and its employees and in which prices, for example, reflected an employee's personal borrowing rate. The IFRIC was asked whether this approach is consistent with the requirements under IFRS 2.

The IFRIC noted the requirements in paragraph B3 of Appendix B to IFRS 2, which states that, 'if the shares are subject to restrictions on transfer after vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.'

The IFRIC noted that this paragraph requires consideration of actual or hypothetical transactions, not only with employees, but rather with all actual or potential market participants willing to invest in restricted shares that had been or might be offered to them.

The IFRIC believed that the issue was not expected to create significant divergence in practice and that the requirements of IFRS 2 are clear. The IFRIC, therefore, [decided] not to take the issue onto the agenda.

IAS 39 *Financial Instruments Recognition and Measurement* - Valuation of electricity derivatives

The IFRIC received a request for guidance on the treatment of certain principal-to-principal derivatives designed to fix the price of a supply of electricity by linking it with a transaction to buy or sell the electricity through an intermediary. In a related agenda decision published in IFRIC Update for August 2005, the IFRIC noted that such derivatives did not fall under the exemption from IAS 39 for contracts for the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. The question therefore arose whether such contracts fell under the exception from valuation in IAS 39 for derivatives linked to unquoted equity instruments and, if not, how they should be valued. Valuation issues included the facts that the derivative had a variable notional amount and that the term of the derivative might extend well beyond the period for which there was any observable market data.

The IFRIC noted that the only exception in IAS 39 from the requirement to fair value derivatives after initial recognition is given in paragraph 46(c), amplified by AG80 and AG81 of that Standard and that it was not appropriate to extend this exemption to the derivatives considered in this request. The IFRIC noted further that IAS 39 contains general principles on how to measure fair value. The IFRIC [decided] that it should not seek to develop more detailed guidance on this topic, since the subject was too specific.

IAS 32 *Financial Instruments: Presentation* - Puts and forwards held by minority interests

The IFRIC considered a request for clarification of the accounting when a parent entity has entered into a forward to acquire the shares held by the [non-controlling] minority interest in a subsidiary or the holder of the [non-controlling] minority interest can put its shares to the parent entity.

Paragraph 23 of IAS 32 states that a parent must recognise a financial liability when it has an obligation to pay cash in the future to purchase the minority's shares, even if the payment of that cash is conditional on the option being exercised by the holder. After initial recognition any liability to which IFRS 3 is not being applied will be accounted for in accordance with IAS 39. The parent will reclassify the liability to equity if a put expires unexercised.

The IFRIC agreed that there is likely to be divergence in practice in how the related equity is reclassified. However, the IFRIC did not believe that it could reach a consensus view on this matter on a timely basis. Accordingly, [the IFRIC decided] not to add this item to its agenda.

Those commenting on the above item and the following one are encouraged to state when, they believe, puts or forwards on shares in a subsidiary should be accounted for under IAS 39 and when under IFRS 3.

IFRS 3 *Business Combinations* - Are puts or forwards received by minority interests in a business combination contingent consideration?

The IFRIC considered a request for an interpretation of whether a put or forward entered into by a parent entity, as part of a business combination, to acquire the shares held by the [non-controlling] minority interest was contingent or deferred consideration.

The accounting for these arrangements, including the circumstances considered by the IFRIC, is being considered by the Board as part of the current redeliberations on the proposed revised IFRS 3 *Business Combinations*. The IFRIC therefore believed that it could not develop guidance more quickly than is likely to be developed in the business combinations project and [decided] not to take a project on this issue onto its agenda.

SIC-12 *Consolidation of Special Purpose Entities* - Relinquishment of control

The IFRIC considered an issue concerning the relative weight to be given to the various indicators in paragraph 10 of SIC-12 *Consolidation of Special Purpose Entities* in determining who should consolidate a special purpose entity (SPE). The issue focused on a situation in which all the decisions necessary for the ongoing activities of the SPE had been predetermined by its creator and in which the majority of the 'equity interest tranche' had been transferred to a third party. The question was whether in such a situation the benefits and risks factors specified in paragraph 10(c) and (d) of SIC-12 took precedence over the factors in paragraph 10(a) (activities of the SPE conducted in accordance with specific business needs of one party) and paragraph 10(b) (one party has decision-making powers or has delegated them by setting up an 'autopilot' mechanism).

The IFRIC noted that, under IAS 27 *Consolidated and Separate Financial Statements*, control, which is the basis for consolidation, has two components: power to govern and rights to obtain benefits.

The IFRIC noted that the factors set out in paragraph 10 of SIC-12 are indicators only and not necessarily conclusive. The IFRIC believed that this approach was deliberate, in acknowledgement of the fact that circumstances vary case by case. In IFRIC's view, SIC-12 requires that the party having control over an SPE should be determined through the exercise of judgement and skill in each case, after taking into account all relevant factors. For this reason, [the IFRIC decided] not to take the issue onto the agenda.

IAS 39 *Financial Instruments: Recognition and Measurement*: Definition of a derivative - Indexation on own EBITDA or own revenue

The IFRIC was asked to provide guidance on the definition of a derivative in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 9 of IAS 39 excludes from the definition of a derivative those contracts whose value changes in response to changes in a non-financial variable that is specific to a party to the contract. The exclusion was introduced by IFRS 4 *Insurance Contracts* to help distinguish insurance contracts from financial instruments.

This had led some to conclude that the exclusion in paragraph 9 for non-financial variables that are specific to a party to the contract applies only to insurance contracts.

The IFRIC noted that there is no explicit statement within the Standard that the exception in paragraph 9 of IAS 39 applies only to non-financial variables that are the subject of insurance contracts.

The IFRIC believed that the exclusion in paragraph 9 of IAS 39 for non-financial variables that are specific to a party to the contract is not restricted to insurance contracts. The IFRIC did not expect significant diversity in practice and therefore [decided] not to add this issue to its agenda.

The IFRIC was also asked to provide guidance on whether a contract that is indexed to an entity's own revenue or own earnings before interest, tax, depreciation and amortisation (EBITDA) meets the definition of a derivative under IAS 39.

As noted above, paragraph 9 of IAS 39 excludes from the definition of a derivative those contracts whose value changes in response to changes in a non-financial variable that is specific to a party to the contract. The IFRIC was, therefore, asked for guidance on whether revenue or EBITDA are financial or non-financial variables.

The IFRIC accepted that it is unclear from the Standard whether revenue or EBITDA are financial or non-financial variables. However, [the IFRIC decided] not to take this issue on to its agenda as it believed it would be unable to reach a consensus on a timely basis.

IAS 32 *Financial Instruments: Presentation* - Foreign currency instruments exchangeable into equity instruments of the parent entity of the issuer

At its meeting in April 2005, the IFRIC concluded that derivative contracts that may be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency are financial liabilities. At the same time, the IFRIC recommended that the issue should be referred to the Board. However, the Board, in September 2005, decided not to proceed with any amendments to IAS 32 *Financial Instruments: Presentation* in connection with convertible instruments issued by an entity in a currency other than the functional currency of the entity.

Subsequently, the IFRIC was asked to consider an issue relating to the issuance by a subsidiary of financial liabilities that provide holders with the rights to exchange the liability instruments into a fixed number of equity instruments of the parent at a fixed amount of currency. Variants considered were that the amount of currency is fixed if it is denominated in (i) the functional currency of the issuer of the exchangeable financial instruments or (ii) the functional currency of the issuer of the equity instruments. The issue was whether the conversion options embedded in the exchangeable financial instruments should be classified as equity in the consolidated financial statements of the parent in accordance with IAS 32 *Financial Instruments: Presentation*.

The IFRIC noted that a group does not have a functional currency. It therefore discussed whether it should add a project to its agenda to address which currency should be the reference point in determining whether the embedded conversion options are denominated in a foreign currency.

The IFRIC believed that the issue is sufficiently narrow that it is not expected to have widespread relevance in practice. [The IFRIC, therefore, decided] not to take the issue onto the agenda.

IAS 32 *Financial Instruments: Presentation* - Changes in the contractual terms of an existing equity instrument resulting in it being reclassified to financial liability

The IFRIC was asked to consider a situation in which an amendment to the contractual terms of an equity instrument resulted in the instrument being classified as a financial liability of the issuer. Two issues were discussed: (i) on what basis the financial liability should be measured at the date when the terms were changed and (ii) how any difference between the carrying amount of the previously recognised equity instrument and the amount of the financial liability recognised at the date when the terms were changed should be accounted for.

The IFRIC noted that at the time when the contractual terms were changed, a financial liability was initially recognised, and, furthermore, that a financial liability on initial recognition is measured at its fair value in accordance with paragraph 43 of IAS 39 *Financial Instruments: Recognition and Measurement*. The IFRIC observed that Example 3 of IFRIC Interpretation 2 *Members' Shares in Co-operative Entities and Similar Instruments* deals with a similar situation. In that example, at the time when the financial liabilities are recognised, when the terms are changed, they are recognised at their fair value.

The IFRIC observed that the change in the terms of the instrument gave rise to derecognition of the original equity instrument. The IFRIC noted that paragraph 33 of IAS 32 *Financial Instruments: Presentation* states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. The IFRIC, therefore, believed that, at the time when the terms were changed, the difference between the carrying amount of the equity instrument and the fair value of the newly recognised financial liability should be recognised in equity.

The IFRIC believed that the requirements of IFRS, taken as a whole, were sufficiently clear and that the issue was not expected to have widespread relevance in practice. [The

IFRIC, therefore, decided] that the issue should not be taken onto the agenda.

IAS 1 *Presentation of Financial Statements* - Whether the liability component of a convertible instrument should be classified as current or non-current

The IFRIC was asked to consider a situation in which an entity issued convertible financial instruments that, in accordance with IAS 32 *Financial Instruments: Presentation*, were accounted for as two elements – an equity component (ie the holders' rights to convert the instruments into a fixed number of equity instruments of the issuer any time before the maturity date) and a liability component (ie the entity's obligation to deliver cash to holders at the maturity date, which was more than one year after the balance sheet date). The issue was whether the liability component should be presented as current or non-current on the face of the issuer's balance sheet.

The IFRIC observed that both IAS 1 *Presentation of Financial Statements* and the *Framework for the Preparation and Presentation of Financial Statements* (the Framework) state that information about the liquidity and solvency of an entity is useful to users. The IFRIC also noted that the definitions of liquidity and solvency refer to the availability of cash to the entity. On that basis, the IFRIC believed that the liability component should be classified as non-current.

On the other hand, the IFRIC noted that paragraph 60(d) of IAS 1 states that a liability should be classified as current if the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date. According to paragraph 62 of the Framework, conversion of an obligation into equity is considered as the settlement of a liability. In addition, according to the definition of a financial liability set out in paragraph 16 of IAS 32, a financial liability may be settled through the delivery of a variable number of the issuer's own equity instruments. Settlement of a liability is not confined to delivery of cash or other assets.

The IFRIC believed that the above IFRS requirements appear to be in conflict. In addition, the IFRIC observed that practice, in determining whether the liability component was classified as current or non-current, focused on when the issuer was obliged to deliver cash or other assets. [The IFRIC decided] not to take the issue onto the agenda. Instead, the IFRIC believed that clarification from the Board on this issue was required.

IFRS 2 *Share-based Payment* - Incremental fair value to employees as a result of unexpected capital restructurings

The IFRIC was asked to consider a situation in which the fair value of the equity instruments granted to the employees of an entity increased after the sponsoring entity undertook a capital restructuring that was not anticipated at the date of grant of the equity instruments. The original share-based payment plan did not provide for any adjustments to the plan in the event of a capital restructuring. As a result, the equity instruments previously granted to the employees became more valuable as a consequence of the restructuring. The issue was whether the incremental value should be accounted for in the same way as a modification to the terms and conditions of the plan in accordance with IFRS 2 *Share-based Payment*.

The IFRIC believed that the case presented was not a normal commercial occurrence and was unlikely to have widespread significance. [The IFRIC, therefore, decided] not to take the issue onto the agenda.

IAS 16 *Property, Plant and Equipment* - Revaluation of investment properties under construction

The IFRIC discussed whether to take on a project to consider whether the revaluation model in IAS 16 is available for investment property under construction.

The IFRIC noted that since IAS 40 was written, the use of fair values in accounting has become more widespread. At the same time, valuation techniques have become more robust. The IFRIC therefore considered that the requirement that investment property under construction be accounted for under IAS 16 may no longer be necessary, and agreed to ask the Board whether it would consider amending IAS 40 to state that investment property under construction should be accounted for under that Standard.

The IFRIC noted that whilst the Basis for Conclusions to IAS 40 implies that investment property under construction may not be revalued, IAS 16 does not preclude accounting for such property using the revaluation model. The IFRIC considered that there may be practical issues in practice in applying the IAS 16 model to investment property under construction.

The IFRIC deferred its discussion on these potential issues, and on whether to take the issue onto its agenda until it received the results of its request to the Board on the subject.

IAS 32 *Financial Instruments: Presentation* - Classification of a financial instrument as liability or equity

At its March 2006 meeting, the IFRIC discussed a submission for a possible agenda item relating to the role of contractual and economic obligations in the classification of financial instruments. At that meeting and the following meeting in May, the IFRIC agreed not to take the item onto the agenda but did not agree on reasons to be given for that decision.

At the July IFRIC meeting, the IFRIC Chairman reported the results of the Board's discussions on the subject from its June 2006 meeting. As stated in the June 2006 IASB Update,

> 'The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument (or a component of a financial instrument) under IAS 32 *Financial Instruments: Presentation*. This issue had previously been debated at the IFRIC meetings in March and May 2006.
>
> For a financial instrument (or a component of a financial instrument) to be classified as a financial liability under IAS 32, the issuer must have a contractual obligation either:
>
> - to deliver cash or another financial asset to the holder of the instrument, or

- to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

(Different requirements apply to financial instruments that may or will be settled in the issuer's own equity instruments.) The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.

The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.'

The IFRIC believed that it would not be able to reach a consensus on this topic on a timely basis and, for that reason and, on the basis that it did not expect significant diversity post publication of the Board's statement, [decided] not to take the issue onto the IFRIC agenda.

Future IFRIC meetings

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

2006

- 7 and 8 September
- 2 and 3 November

2007

- 11 and 12 January
- 8 and 9 March
- 3 and 4 May
- 12 and 13 July
- 6 and 7 September
- 1 and 2 November

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. Instructions for submitting requests for Interpretations are given on the IASB Website at www.iasb.org/about/ifric.asp