NEWSLETTER OF THE INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

IASB IFRIC UPDATE

March 2008

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 Draft Interpretation, which is confirmed by the IASB.

The IFRIC met in London on 6 March 2008, when it discussed:

- IFRIC D21 *Real Estate Sales*
- IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*
- IFRIC agenda decisions
- Tentative agenda decisions
- IFRIC work in progress

IFRIC D21 *Real Estate Sales*

At its meeting in January 2008 the IFRIC considered comments received on D21 *Real Estate Sales* and directed the staff to develop a flowchart to illustrate the accounting for real estate sale agreements in accordance with IAS 11 *Construction Contracts* and IAS 18 *Revenue*, with the starting point being to consider the nature of the sale ('what has been sold?').

At this meeting, the staff presented a flowchart divided into two parts. The first part of the flowchart dealt with the identification of the real estate sale and the second part with the applicable standard and revenue recognition.

Identification of the real estate sale

The first part of the flowchart illustrated that IAS 18 is the relevant Standard to identify the nature of the real estate sale agreement because the guidance in paragraph 13 of IAS 18 is expressed at a general level. Therefore, in accordance with IAS 18, an entity should identify whether a single agreement for the sale of real estate has one component or multiple components. The staff noted that this approach is consistent with IFRIC 12 *Service Concession Arrangements* (paragraph BC31), which identifies a component for construction services within IAS 11 and a component for operating the asset constructed within IAS 18. Lastly, this part of the flowchart noticed that IAS 18 requires the fair value of the consideration received or receivable to be allocated to each identified component. The staff proposed that, in the Interpretation, no detailed guidance would be given on this allocation but rather a reference would made to existing guidance in IFRIC 12 and IFRIC 13 *Customer Loyalty Programmes*.

The IFRIC supported this first part of the flowchart but asked the staff to clarify what was meant by 'real estate sale component'. In particular, the IFRIC wanted to clarify whether, in the flowchart, the sale of land would be identified as a separate component within the scope of IAS 18 at the early stage of analysing the transaction or included in the real estate sale component and treated as a separate component at a later stage.

Applicable standard and revenue recognition

The second part of the flowchart addressed the issues of:

- whether the real estate sale agreement (or component) should be regarded as a construction contract within the scope of IAS 11 or an agreement for the sale of goods within the scope of IAS 18; and
- how revenue from the sale of real estate should be recognised.

The IFRIC agreed with the flowchart that the first question should be whether the real estate agreement meets the definition of a construction contract. The IFRIC concluded that some guidance developed in D21 helps distinguish between construction and the custom assembly of goods from predefined vendor options and should be included in the Interpretation.

Then, the staff presented two alternative views for real estate sale agreements that do not meet the definition of a construction contract but in which the criteria in paragraph 14(a) and (b) of IAS 18 for recognising revenue (that the seller transfers to the buyer control and the significant risks and rewards of ownership) are met as construction progresses:

- View 1: such agreements should be considered construction contracts and should be included within the scope of IAS 11 (view taken in D21). Revenue and costs are recognised by reference to the stage of completion.
- View 2: such agreements are within the scope of IAS 18 because they are not construction contracts. However, because all the criteria for revenue recognition for the sale of goods in IAS 18 are met on a continuous basis, the percentage of completion method appropriately recognises revenue. The entity should refer to IAS 11 for application guidance because the requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

The IFRIC noted that both views produce similar revenue recognition answers. However, under View 2, the segmentation and disclosure requirements for the real estate sale agreement are those of IAS 18 and therefore are less restrictive than IAS 11 (View 1). The IFRIC agreed with some respondents to D21 who noted that the 'control and risks and rewards' test was not a requirement of IAS 11 and generally supported View 2.

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However, in the flowchart, the IFRIC did not find the term 'continuous sale of goods' relevant and asked the staff to clarify the wording. Some IFRIC members asked the staff to consider whether the continuous sale of goods might be indicative that the essence of the arrangement involved the rendering of services. The IFRIC also asked the staff to address the issue of disclosures.

Lastly, the flowchart illustrated that, when the real estate sale agreement meets neither the definition of a construction contract nor transfers to the buyer control and the significant risks and rewards of ownership of the work in progress as construction progresses, the real estate sale is a sale of goods under IAS 18 (completed real estate). The IFRIC reaffirmed that, in such a situation, revenue is recognised when all the conditions in paragraph 14 of IAS 18 have been satisfied. The IFRIC directed the staff to circulate an amended version of the flowchart and to bring to the next IFRIC meeting a new draft of the Interpretation and the illustrative examples based on View 2.

IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*

At its meeting in January 2008, the IFRIC directed the staff to develop comprehensive examples to illustrate and clarify the main conclusions in D22 *Hedges of a Net Investment in a Foreign Operation*. The examples the staff had developed illustrated the effects of holding different hedging instruments by different entities within a group and of different methods of consolidation. At this meeting, the staff presented the comprehensive examples to the IFRIC and asked for direction on how to proceed with this project.

The IFRIC discussed hedge accounting, the application of different consolidation methods and recycling of accumulated amounts recognised outside profit or loss on disposal of a foreign operation. The IFRIC reached the following conclusions:

- in the financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. The amount of net investment eligible to be hedged at each parent level depends on whether any lower level parent companies have already hedged the risk of the net assets of their foreign operations (ie the amount of the net investment to be hedged for the same risk cannot be duplicated in the consolidated financial statements).
- the fact that the net investment is held through an intermediate company does not affect the economic risk. A parent entity can hedge the risk of a net investment it holds indirectly.
- the hedging instrument may be held by any entity within a group (other than the foreign operation being hedged) and neither where the hedging instrument is held nor the method of consolidation that a group uses affects the assessment of the effectiveness of the hedge.
- when an entity hedges a net investment in a foreign operation, IAS 39 *Financial Instruments: Recognition and Measurement* requires it to identify the amounts included in the group's foreign currency translation reserve (FCTR) in respect of that foreign operation as a result of applying hedge accounting. Thus, when a foreign operation that was hedged is disposed of, the amount recycled to profit or loss from the group's FCTR in respect of the hedging instrument will always be the amount that IAS 39 requires to be identified.
- when a foreign operation is disposed of, IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires any amount included in the group's FCTR in respect of that foreign operation to be included in profit or loss. The determination of this amount may depend on whether the FCTR in the ultimate parent's group financial statements is based on intermediate consolidations when the step-by-step method of consolidation is applied. The IFRIC noted that although the amount determined by the direct method is the conceptually correct amount of FCTR for an individual foreign operation, IAS 21 does not require an entity to use this method or to make adjustments to produce the same result.

The IFRIC discussed a number of other application issues raised in the comment letters and agreed with the staff's recommendation that, other than clarifying the transition requirements, none of the issues needed to be addressed in the interpretation itself. The IFRIC also agreed that the staff should consider and make recommendations on whether to include examples in the interpretation and, if so, the issues they should illustrate.

The IFRIC directed the staff to draft the final interpretation reflecting the conclusions reached in the redeliberations.

IFRIC agenda decisions

The following explanation is published for information only and does not change existing IFRS requirements. *IFRIC agenda decisions are not Interpretations. IFRIC Interpretations 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 7 *Statement of Cash Flows*—Classification of expenditures

The IFRIC received a request for guidance on the treatment of some types of expenditure in the statement of cash flows. In practice some entities classify expenditures that are not recognised as assets under IFRSs as cash flows from operating activities while others classify them as part of investing activities. Examples of such expenditures are those for exploration and evaluation activities (which can be recognised, according to the applicable standard, as an asset or an expense). Advertising and promotional activities, staff training and research and development could also raise the same issue.

The IFRIC concluded that the issue could be best resolved by referring it to the Board with a recommendation that IAS 7 should be amended to make explicit that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activity. The IFRIC therefore decided not to add the issue to its agenda.

Tentative agenda decisions

The IFRIC reviewed the following matters and tentatively decided that they should not be added to the IFRIC agenda. These tentative decisions, including recommended reasons for not adding the items to the IFRIC agenda, will be reconsidered at the IFRIC meeting in May 2008. Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are encouraged to communicate those concerns by 14 April 2008 by email to: ifric@iasb.org.

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

IAS 19 *Employee Benefits*—Settlements

The IFRIC received a request to clarify whether some payments of benefits under a defined benefit plan are settlements as defined in IAS 19. The payments in question arise when an existing plan gives plan members the option to choose to receive a lump sum payment at retirement instead of ongoing payments.

The IFRIC noted that events that are covered by the actuarial assumptions underlying the measurement of the defined benefit obligation are not treated as settlements under IAS 19. The IFRIC [decided] not to add the issue to its agenda because there was little diversity in practice.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* —Deposits on returnable containers

The IFRIC was asked to provide guidance on the accounting for the obligation to refund deposits on returnable containers. In some industries, entities that distribute their products in returnable containers collect a deposit for each container delivered and have an obligation to refund this deposit when containers are returned by the customer. The issue is whether the obligation should be accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.*

The IFRIC noted that paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a financial instrument as 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.' Following delivery of the containers to its customers, the seller has an obligation only to refund the deposit for any returned containers.

In circumstances in which the containers are derecognised as part of the sale transaction, either completely at the time of the first sale or partially by depreciation over a number of sales, the obligation is an exchange of cash (the deposit) for the containers (non-financial assets). Whether that exchange transaction occurs is at the option of the customer. Because the transaction involves the exchange of a non-financial item, it does not meet the definition of a financial instrument in accordance with IAS 32 and is therefore is not within the scope of IAS 39.

In contrast, when the containers are not derecognised as part of the sale transaction, the customer's only asset is its right to the refund. In such circumstances, the obligation meets the definition of a financial instrument in accordance with IAS 32 and is therefore within the scope of IAS 39. In particular, paragraph 49 of IAS 39 states that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.'

The IFRIC concluded that divergence in this area was unlikely to be significant and therefore [decided] not to add this issue to its agenda.

IFRIC work in progress

The IFRIC reviewed a summary of its outstanding issues. The staff noted that five topics had been discussed at the meeting. For three other active topics, the comment period had not yet expired for documents that were published for comment. Two new requests for interpretation had been received and were being analysed by staff in order to make a recommendation on whether the IFRIC should add the issues to its agenda. The final issue, relating to derecognition, was not active as it was still awaiting the allocation of staff resources.

The staff expect that the IFRIC will complete its discussions of D21 and D22 at its meeting in May and that an analysis of the comments received on D23 *Non-cash Asset Distributions to Owners* and D24 *Customer Contributions* will be presented at the meeting in July.

From July 2006, IFRIC meetings have been audiocast live via the Internet. Audio recordings are available to listen to via the Website and can be accessed via the IFRIC Projects included within the Current Projects area. Please visit the IASB Website at www.iasb.org for more information.

Future IFRIC meetings

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

2008

- 8 and 9 May
- 10 and 11 July
- 4 and 5 September
- 6 and 7 November

In addition to the meetings listed above, the IFRIC may hold meetings for a preliminary discussion of some staff papers. Attendance by IFRIC members at these meetings is voluntary and no decisions on technical issues will be made. If the IFRIC holds a preliminary meeting, it will normally take place on the Wednesday afternoon before the IFRIC meeting.

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 http://www.iasb.org/About+Us/About+IFRIC/Propose+Agenda+Item.htm