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# HKFRS / IFRS UPDATE 2015/03

## IFRS INTERPRETATIONS COMMITTEE – AGENDA REJECTIONS (NOVEMBER 2014)


**STATUS**
Final

**EFFECTIVE DATE**
Immediate

**ACCOUNTING IMPACT**
Clarification of HKFRS/IFRS requirements. May lead to changes in practice.

## Background

This Update summarises issues that the IFRS Interpretations Committee (the Interpretations Committee) decided not to take onto its agenda at its November 2014 meeting, which were reported in its public newsletter (the IFRIC Update). Although these agenda rejections do not represent authoritative guidance issued by the International Accounting Standards Board (IASB), in practice they are regarded as being highly persuasive. All entities that report in accordance with IFRS need to be aware of these agenda rejections, and may need to modify their accounting approach. More detailed background about agenda rejections is set out below.

The Interpretations Committee is the interpretative body of the IASB. The role of the Interpretations Committee is to provide guidance on financial reporting issues which have been identified and which are not specifically addressed in IFRS, or where unsatisfactory or conflicting interpretations either have developed, or appear likely to develop.

Any party which has an interest in financial reporting is encouraged to submit issues to the Interpretations Committee when it is considered to be important that the issue is addressed by either the Interpretations Committee itself, or by the IASB. When issues are raised, the Interpretations Committee normally consults a range of other parties, including national accounting standard setting bodies, other organisations involved with accounting standard setting, and securities regulators.

At each of its meetings, the Interpretations Committee considers new issues that have been raised, and decides whether they should be added to its agenda. For those issues that are not added to the agenda, a tentative agenda decision is published in the IFRIC Update newsletter which is issued shortly after each of the Interpretations Committee's meetings. These tentative agenda decisions are open to public comment for a period of 60 days, after which point they are taken back to the Interpretations Committee for further consideration in the light of any comment letters which have been received and further analysis carried out by the Staff. The tentative agenda decision is then either confirmed and reported in the next IFRIC Update, or the issue is either subjected to further consideration by the Interpretations Committee's agenda or referred to the IASB.

Interpretations Committee agenda decisions do not represent authoritative guidance. However, they do set out the Interpretations Committee's rationale for not taking an issue onto its agenda (or referring it to the IASB). It is noted on the IFRS Foundation's website that they 'should be seen as helpful, informative and persuasive'. In practice, it is expected that entities reporting in accordance with IFRS will take account of and follow the agenda decisions and this is the approach which is followed by securities regulators worldwide.

Given that HKFRS is fully converged with IFRS, these agenda decisions are also informative and persuasive to HKFRS financial statements preparers. HKFRS has identical financial reporting standard and paragraph references as IFRS. For example, if a reference is made to "IFRS 12.10" the equivalent HKFRS paragraph is "HKFRS 12.10".

## Agenda decisions that were finalised at the November 2014 meeting

*IFRS 12 Disclosure of Interests in Other Entities – Disclosure of summarised financial information about material joint ventures and associates*

*IAS 16 Property, Plant and Equipment and IAS 2 Inventories – Accounting for core inventories*

*IAS 21 The Effects of Changes in Foreign Exchange Rates – Foreign exchange restrictions and hyperinflation*

*IAS 39 Financial Instruments: Recognition and Measurement – Holder's accounting for exchange of equity instruments*

## Tentative agenda decisions at the November 2014 meeting

*IFRS 10 Consolidated Financial Statements – Single-asset, single lessee lease vehicles and the assessment of control under IFRS 10. In what circumstances does the lender or lessee consolidate?*

*IFRS 10 Consolidated Financial Statements – Control of a structured entity by a junior lender*

*IFRS 11 Joint Arrangements – Classification of joint arrangements: The assessment of 'other facts and circumstances'*

*IFRS 11 Joint Arrangements – Classification of joint arrangements: Application of 'other facts and circumstances' to specific fact patterns*

*IFRS 11 Joint Arrangements – Classification of joint arrangements: consideration of two joint arrangements with similar features that are classified differently*

*IFRS 11 Joint Arrangements – Accounting by the joint operator: recognition of revenue by the joint operator*

*IFRS 11 Joint Arrangements – Accounting by the joint operator: the accounting treatment when the joint operator's share of output purchased differs from its share of ownership interest in the joint operation*

*IFRS 11 Joint Arrangements – Accounting in separate financial statements: accounting by the joint operator in its separate financial statements*

*IFRS 11 Joint Arrangements – Accounting by the joint operation: accounting by the joint operation that is a separate vehicle in its financial statements*

*IAS 12 Income Taxes – Selection of applicable tax rate for measurement of deferred tax relating to investment in associate*

*IAS 19 Employee Benefits – Should longevity swaps held under a defined benefit plan be measured at fair value as part of plan assets or on another basis as a qualifying insurance policy?*

Each of these is discussed below, split between those which are expected to have wide application and those which are narrower in focus.

## Agenda decisions at the November 2014 meeting – wide application

### *IFRS 12 Disclosure of Interests in Other Entities – Disclosure of summarised financial information about material joint ventures and associates*

The disclosure in IFRS 12.21(b)(ii) about the nature, extent and financial effects of an entity's interests in joint ventures and associates requires an entity to disclose summarised financial information about material joint ventures and associates. Although the standard states that this information should be disclosed for each material joint venture or associate, it was unclear how this should be read in conjunction with the general aggregation principle in IFRS 12.4 and .B2-B6 which require an entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the requirements in this IFRS.

The Interpretations Committee concluded that the disclosure of an entity's interests in joint ventures and associates that is material to the entity is to be summarised on an individual basis for each joint venture or associate.

Furthermore the Interpretations Committee noted that IFRS 12 requires the disclosure of the information required by IFRS 12.21(b)(ii) even if the information related to a listed joint venture or associate and local regulatory requirements prevent the investor from disclosing such information until the joint venture or associate has released its own financial statements.

*BDO comment*

*This clarifies that an entity is not allowed to apply the general aggregation principle of IFRS 12.4 in order to aggregate summarised financial information about joint ventures and associates according to IFRS 12.21(b)(ii). Accordingly, the scope of the overall aggregation principle in IFRS 12.4 is further narrowed and might have an impact on further judgements with regard to other disclosure requirements of IFRS 12.*

*The further clarification that IFRS 12 does not address situations where entities are restricted from getting the necessary information to fulfil the disclosure requirements may mean that entities will need to plan their reporting dates around the points at which financial information is to be released by their joint ventures and/or associates.*

## Agenda decisions at the November 2014 meeting – narrow application

*IAS 39 Financial Instruments: Recognition and Measurement – Holder's accounting for exchange of equity instruments*

In certain situations entities are required to account for exchange existing equity instruments for new equity instruments with different terms. The question which then arises is whether the exchange gives rise to the derecognition of the old and the recognition of a new financial instrument. The issue that was brought forward to the Interpretations Committee involved equity instruments issued by the central bank and the exchange of instruments was imposed as a consequence to a change in legislation.

The Interpretations Committee did not take this issue onto its agenda because of:

- The unique nature of the transaction; and
- A lack of significant diversity for the accounting for this transaction among the holders of the equity instruments.

*IAS 16 Property, Plant and Equipment and IAS 2 Inventories – Accounting for core inventories*

Some items of property, plant and equipment (for example, an oil refinery) need to be filled with a minimum amount of material (in this case oil) in order to be able to operate. The material cannot be physically separated from the property, plant and equipment and is only capable of being removed either when the facility (in this case the oil refinery) is decommissioned, or at a substantial cost.

The Interpretations Committee had previously concluded that it should develop an interpretation. However, feedback received indicated that the fact patterns for arrangements involving core inventories vary significantly. Although diversity in approach was noted among different industries, diversity was not noted within specific industry sectors. It was observed that what constitutes core inventories, and how they are accounted for, can vary between industries and that disclosure about such judgment in accordance with IAS 1.122 is required. At the same time the Interpretations Committee had no clear evidence that the accounting differences were caused by differences in how IAS 2 and IAS 16 were applied. Consequently, it was decided to remove this item from its agenda.

*IAS 21 The Effects of Changes in Foreign Exchange Rates – Foreign exchange restrictions and hyperinflation*

The selection of the applicable exchange rate for investments in foreign operations requires judgement and is challenging when:

- Multiple exchange rates exist; and
- A long term lack of exchangeability exists.

The issue was raised in respect of an investment in a foreign operation in Venezuela where several official exchange rates and restrictions over the amount of local currency that can be exchanged exist.

The Interpretations Committee noted that guidance in IAS 21.26 is often followed for the selection of the appropriate exchange rate in situations where multiple exchange rates exist. The rate to be used is therefore the rate at which the transaction could have been settled if the cash flows had occurred at the measurement date. Therefore, the Interpretations Committee decided not to take this first issue onto its agenda.

However, it was also noted that the second issue, which is a long term lack of exchangeability, is not addressed by IAS 21. Due to the broad scope of the issue, which is wider than the Interpretations Committee is able to address, the Interpretations Committee decided not to take this second issue onto its agenda.

However, the Interpretations Committee noted that a number of disclosure requirements apply when the effects of foreign exchange controls are material to an understanding of the financial statements. These include:

- Significant accounting policies and significant judgements in their application (IAS 1.117-124)
- Sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. This may include a sensitivity analysis. (IAS 1.125-133)
- The nature and extent of significant restrictions on an entity's ability to access or use assets, and to settle liabilities of the group, or its joint ventures or associates (IFRS 12.10, .13, .20 and .22).

## Tentative agenda decisions at the November 2014 meeting – wide application

*BDO comment*

*At its November 2014 meeting, the Interpretations Committee concluded its discussions about a number of issues relating to IFRS 10 Consolidated Financial Statements and IFRS 11 Joint Operations. Following discussion about the way in which the results of those discussions should be published, it was concluded that the most appropriate approach would be as a series of agenda decisions, rather than as a form of educational material.*

### *IFRS 11 Joint Arrangements – Classification of joint arrangements: the assessment of 'other facts and circumstances'*

The Interpretations Committee was asked to clarify the assessment of 'other facts and circumstances' with regard to the classification of a joint arrangement as either a joint operation or a joint venture in accordance with paragraph 17 of IFRS 11. Consideration was given to whether the assessment should only focus on whether those facts and circumstances create enforceable rights to the assets and obligations for the liabilities of the joint arrangement, or whether it should also consider:

- The design and purpose of the joint arrangement
- The entity's business needs and
- The entity's past practices.

The Interpretations Committee noted that the initial assessment of whether a joint arrangement gives rise to a joint operation or a joint venture focuses on whether the parties to the joint arrangement have enforceable rights to assets and obligations for the liabilities. The assessment of 'other facts and circumstances' is made when no contractual arrangement exists to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle. The assessment therefore focuses on whether enforceable rights to the assets and obligations for the liabilities have been established through the other facts and circumstances.

In its conclusion, the Interpretations Committee refers to paragraphs B31-B33 of IFRS 11 and concludes that a joint arrangement is classified as a joint operation through the assessment of other facts and circumstances if:

- The parties have rights and obligations relating to the economic benefits of the assets; and
- The parties provide cash to the arrangement through legal or contractual obligations, which is used to settle the liabilities of the joint arrangement on a continuous basis.

Accordingly, the assessment of 'other facts and circumstances' is a test of whether these facts and circumstances override the rights and obligations conferred by the legal form of the separate vehicle, resulting in the parties to the joint arrangement having enforceable rights to assets and obligations for liabilities. The assessment is not a test of whether parties are closely or fully involved with the operation of the separate vehicle.

### *IFRS 11 Joint Arrangements – Classification of joint arrangements: application of 'other facts and circumstances' to specific fact patterns*

#### *Output sold at market price*

An issue was raised in which the output of the joint arrangement is sold to the parties of the joint arrangement at market rates and whether this prevents the joint arrangement from being classified as a joint operation. This is because the market price of output could fall to the extent that the income received by the joint arrangement might not be sufficient for it to settle all of its obligations.

The Interpretations Committee clarified that a sale at market price to the other parties is not determinative on its own. Instead it would be necessary to consider, among other things, whether the cash flows provided through the transaction would be sufficient to enable the joint arrangement to settle its liabilities on a continuous basis.

Consequently, in these circumstances, judgement is required in determining whether the arrangement is a joint operation or a joint venture.

### *Financing from a third party*

The Interpretations Committee discussed whether financing provided by a third party would prevent a joint arrangement from being classified as a joint operation.

It was noted that it would be necessary to assess whether the cash flows from the sale of the output to the parties to the joint arrangement would fund the repayment of the external financing. If so, the third-party financing alone would not affect the classification of the joint arrangement.

### *Nature of output*

The Interpretations Committee discussed whether the nature of the output (fungible or bespoke) produced by a joint arrangement determines its classification.

The Interpretations Committee noted that the nature of the output is not determinative of its classification. Additionally, it was noted that the focus on obligations for the liabilities in IFRS 11 is on the existence of cash flows flowing between the parties and the joint operation as a consequence of the rights to the assets and obligations for the assets of the joint arrangement regardless of the nature of the product.

### *The basis of 'substantially all of the output'*

A further question was in respect of the basis for determining whether the parties to the joint arrangement are taking 'substantially all of the output'. More specifically the question was whether the basis for determination should be based either on:

- Volumes of output; or
- Monetary value of output.

The Interpretations Committee noted that the assessment needs to be based on the monetary value of the output and not on its physical quantities. In doing so, it referred to paragraphs B31-B32 of IFRS 11 and states that in order to meet the criteria for classifying the joint arrangement as a joint operation through 'other facts and circumstances'

- The parties should have rights to substantially all of the economic benefits of the assets of the joint arrangement and
- The joint arrangement should be able to settle its liabilities from the cash flows received as a consequence of the parties' rights and obligations for the assets.

## *IFRS 11 Joint Arrangements – Classification of joint arrangements: consideration of two joint arrangements with apparently similar features that are classified differently*

Questions were raised about circumstances in which two joint arrangements are basically the same, with the only difference being that one of them has been structured through a separate vehicle and one has not, and whether this might result in a different classification. It was suggested that this could arise for the following reasons:

- For a joint arrangement structured through a separate legal entity, the legal form of the joint arrangement must be overridden by other contracts or other facts and circumstances in order for it to be classified as a joint operation; but
- A joint arrangement which is not structured through a separate vehicle is classified as a joint operation.

The Interpretations Committee confirmed that there might be cases where the structuring of a joint arrangement through a separate vehicle would result in a different classification conclusion, because the legal form often affects the rights and obligations of the parties to the joint arrangement. It was further noted that this does not conflict with the concept of economic substance, because economic substance requires the classification to be made based on the rights and obligations of the parties. A separate vehicle can play a significant role in the assessment of the rights and obligations of the parties to a joint arrangement.

## *IFRS 11 Joint Arrangements – Accounting by the joint operator: recognition of revenue by the joint operator*

IFRS 11.20(d) requires a joint operator to recognise revenue in respect of its share of revenue from the sale of the output by the joint operation. This raised the question of whether a joint operator should recognise revenue in relation to its share of the output purchased from the joint operation.

The Interpretations Committee noted that the issue relates to the application of paragraph 20(d) of IFRS 11 and that it would not result in the recognition of revenue by a joint operator when it purchases output from the joint operation. If the joint operators purchase all of the output from the joint operation, they would recognise 'their revenue' only when they sell the output to third parties.

*IFRS 11 Joint Arrangements – Accounting by the joint operator: the accounting treatment when the joint operator's share of output purchased differs from its share of ownership interest in the joint operation*

In some situations, a joint operator's share of the output purchased might differ from its share of ownership interest in the joint operation. The Interpretations Committee was asked whether the joint operator's share of assets, liabilities, revenue and expenses should be based on:

- The percentage of ownership of the legal entity; or
- The percentage of output purchased.

The Interpretations Committee noted that there are various factors that might need to be considered. These include, for example, varying shares of output purchased by each entity over time and the time period to consider in assessing the share of output. Significant investments by the joint operator that differ from the ownership interest might explain the difference in the share of ownership and share of output, as might other features of the arrangement.

Due to the various possible scenarios, it was noted that it is important to understand each the nature of each case to understand why the share of ownership interest differs from the output share purchased. Judgement would therefore be required in determining the appropriate accounting approach.

*IFRS 11 Joint Arrangements – Accounting in separate financial statements: accounting by the joint operator in its separate financial statements*

The Interpretations Committee was asked how the joint operator accounts for its share of assets and liabilities of a joint operation within its separate financial statements when the joint operation is structured through a separate vehicle.

IFRS 11.26 requires a joint operator to account for its rights and obligations in relation to the joint operation and that those rights and obligations are the same whether separate or consolidated financial statements are prepared. Consequently, the same accounting need to be applied in the consolidated and separate financial statements of an entity. The joint operator would not additionally account in its separate financial statements for its shareholding in the vehicle.

*IFRS 11 Joint Arrangements – Accounting by the joint operation: accounting by the joint operation that is a separate vehicle in its financial statements*

The recognition of assets and liabilities by joint operators in consolidated and separate financial statements raised the question as to whether those assets and liabilities should also be recognised in financial statements of the joint operation itself.

The Interpretations Committee noted that IFRS 11 is only applicable to the accounting by the joint operators and not to the accounting by the separate vehicle. Instead the financial statements of an entity are prepared in accordance with the applicable standards. However, it was also noted that it would be important to understand the joint operators' rights and obligations in respect of those assets and liabilities, and how those rights and obligations affect the related assets and liabilities.

*IAS 12 Income Taxes – Selection of applicable tax rate for measurement of deferred tax relating to investment in associate*

The Interpretations Committee was asked to clarify which tax rate would need to be used for the measurement of deferred taxes relating to an investment in an associate in multi-tax rate jurisdictions. Three possible situations exist of how the carrying amount of the investment might be recovered, each situation giving rise to a different tax rate:

- Dividends received
- Sale to a third party
- Liquidation and the receipt of the residual assets.

The Interpretations Committee referred to IAS 12.51A which states that an entity measures deferred taxes using the tax rate and the tax base consistent with the expected manner of recovery. If the investor considers that an investment will be recovered in more than one way and, as a result different tax rates are expected to apply, these different tax rates would also be applied for the calculation of the deferred tax in accordance with IAS 12.

*BDO comment*

*Entities in jurisdictions with various tax rates will need to give careful consideration to the way in which they expect to recover the carrying amount of the investment and whether this will be through transactions to which different tax rates apply. This might be different from current practice.*

## Tentative agenda decisions at the November 2014 meeting – narrow application

*IAS 19 Employee Benefits – Should longevity swaps held under a defined benefit plan be measured at fair value as part of plan assets or on another basis as a qualifying insurance policy?*

Entities that use longevity swaps held under a defined benefit pension plan can account for the longevity swaps either

- As a single instrument and measure its fair value as part of the plan assets in accordance with IAS 19.8 and .113 and IFRS 13 and record changes in the fair value in other comprehensive income or
- Split the instrument for accounting purposes and use another measurement basis for a qualifying insurance policy for one of the components applying IAS 19.115.

Outreach carried out by the Interpretations Committee indicated that the use of longevity swaps is not widespread. However, when longevity swaps are used, predominant practice is for separate accounting at fair value as part of the plan assets in accordance with IAS 19.8 and .113 and IFRS 13.

*IFRS 10 Consolidated Financial Statements – Control of a structured entity by an operating lessee*

The accounting for structured entities that are set up to lease a certain asset to the lessee requires judgement with regard to the interaction between IFRS 10 and IAS 17. The submission described an example where the structured entity was set up to lease a single asset to a single lessee. The submitter asked whether the lessee controlled the structured entity in this specific case.

The Interpretations Committee concluded that the existing guidance in IFRS 10 would enable entities to conclude whether the entity is controlled by the lessee or not. It further noted that it is not the Interpretations Committee's normal practice to provide guidance on a specific fact pattern.

*IFRS 10 Consolidated Financial Statements – Control of a structured entity by a junior lender*

The submission described a specific case where a structured entity is created to lease a single asset to a single lessee. The structured entity is financed by a junior and a senior lender and in the submission the question was whether the junior lender controls the entity.

As with the issue described before, the Interpretations Committee tentatively decided to reject the issue and noted that the existing principles in IFRS 10 are sufficient to assess the question of control in this case. It was noted that no diversity in practice had been identified in this case, and that it is not the Interpretations Committee's normal practice to provide guidance on a specific fact pattern.

## BDO's support and assistance on HKFRS/IFRS

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