IASB

NEWS FROM THE SIC

No. 17 / August 2001

The Standing Interpretations Committee (SIC) met on 7 August in London, when it:

- considered a proposed final Interpretation based on Draft Interpretation SIC-D27 and agreed to submit it to the Board for approval; and
- agreed to issue two Draft Interpretations on topics relating to potential voting rights and the classification and measurement of financial instruments redeemable for cash, subject to negative clearance by the Board.

Final Interpretation

- *Evaluating the Substance of Transactions in the Legal Form of a Lease*

The SIC considered a proposed final Interpretation based on SIC-D27, *Transactions in the Legal Form of a Lease and Leaseback*, which addresses arrangements where an enterprise enters into a transaction or series of structured transactions with an unrelated party or parties that involves the legal form of a lease. In contrast to SIC-D27, the proposed final Interpretation focuses more upon the principles involved as a result of comments received from commentators and the Board, and contains additional examples of applying certain aspects of the consensus. No fundamental changes have been made to what was in D27. Consequently, some of the information previously contained in the Appendices and the basis for concluding on the particular fact pattern in SIC-D27 has now been incorporated into the consensus.

The SIC agreed that a series of transactions is linked and accounted for as one transaction when the overall economic reality cannot be understood without reference to the series of transactions as a whole.

IAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. The SIC agreed that the following indicators individually demonstrate that an arrangement may not, in substance, involve a lease:

(a) an enterprise retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement; and

(b) an option is included on terms that make its exercise highly likely.

The definitions and guidance in paragraphs 49-64 of the Framework are applied in determining whether, in substance, an asset and a liability exist. The SIC agreed that the following indicators collectively demonstrate that, in substance, a separate investment account and lease payment obligation do not meet the definitions of assets and liabilities:

(a) the enterprise is not able to control the investment account in pursuit of its own objectives and is not obligated to pay the lease payments;

(b) there is no more than a remote and insignificant risk of an obligation to pay back any fee received and possibly some additional amount; and

(c) other than the initial cash flows at inception of the arrangement, the only subsequent cash flows expected are the lease payments that are satisfied from funds withdrawn from the separate investment account established with the initial cash flows.

The SIC agreed that the criteria in paragraph 20 of IAS 18 are applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income. Factors such as whether there is continuing involvement in the form of significant future performance obligations necessary to earn the fee, whether there are retained risks, the terms of any guarantee arrangements, and the risk of repayment of the fee, are considered. The Committee agreed that the following indicators individually demonstrate that recognition of the entire fee as income when received is inappropriate:

(a) obligations either to perform or to refrain from certain significant activities are conditions of earning the fee;

(b) limitations are put on the use of the underlying asset that have the practical effect of restricting and significantly changing the Enterprise's ability to use the asset; and

(c) the possibility of an obligation to pay back some or all of the fee and possibly some additional amount is more than remote.

News From The SIC is published immediately after every SIC meeting by the International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom.

IASB Publications Department, 7th Floor, 166 Fleet Street, London EC4A 2DY,United Kingdom.
Tel: +44 (020) 7427-5927 Fax: +44 (020) 7353-0562
E-Mail: iasb@iasb.org.uk
Internet: http://www.iasb.org.uk
ISSN 1369-6521

The proposed Interpretation will become effective on the date of issuance, and any necessary change in accounting policy as a result is accounted for according to the transition requirements of IAS 8.46.

Further drafting revisions will be considered before the final Interpretation is submitted to the Board for approval.

Draft Interpretations

The SIC reached a consensus on the following agenda items:

- *Consolidation/Equity Method - Potential Voting Rights*

  IAS 27 requires a parent that issues consolidated financial statements to consolidate investees that it controls. IAS 28 requires an investee that is significantly influenced to be accounted for using the equity method.

  The SIC continued its discussion of various circumstances when potential voting rights (e.g., those relating to share warrants and call options, and debt and equity instruments that are convertible into ordinary shares) are considered when assessing whether an enterprise controls or significantly influences another enterprise. The Committee agreed that the existence and effect of all potential voting rights, including those held by other enterprises, that are presently owned and are either presently exercisable or convertible, and give an enterprise the right to acquire additional voting power are considered.

  The Committee also discussed whether the proportion allocated to the parent and minority interest in preparing consolidated financial statements, and the proportion allocated to an investor that accounts for its investment in an associate using the equity method, are determined based on present ownership interests or ownership interests that would be held if the potential voting rights were exercised or converted. The Committee agreed that the proportion allocated is determined solely based on the present ownership interests.

  The Committee intends to include an appendix to the Draft Interpretation with examples of how potential voting rights affect an assessment of whether control or significant influence exists.

  Further drafting revisions will be considered before the Draft Interpretation is submitted to a negative clearance process of the Board.

Next Meeting – The next SIC meeting will be held on 12 and 13 November 2001 in London. Future SIC meeting dates and locations will likely be scheduled to coincide with Board meetings. The tentative agenda and additional details will be posted to the IASB homepage at www.iasb.org.uk prior to the meeting.

- *Financial Instruments – Instruments or Rights Redeemable by the Holder for Cash*

  Enterprises may issue a financial instrument or provide a right that gives the holder the right to put it back to the issuer for cash. The amount of cash payable upon redemption is determined based on a variable index that has the potential to increase and decrease (e.g., an equity instrument, an invested amount, a specified notional amount, or the net value of certain assets and liabilities).

  In some circumstances, the legal form of such an instrument or right includes a right to the residual interest in the assets of the enterprise after deducting its liabilities. For example, open-ended mutual funds, partnerships and certain co-operative enterprises may issue units that are redeemable at any time by the unitholder for cash equal to the unitholder's proportionate share of the net asset value of the enterprise.

  The SIC continued its discussions of the appropriate classification of such an instrument and agreed that the entire instrument is a liability under IAS 32. The Committee also agreed that the instrument is a hybrid financial instrument consisting of a host debt component and an embedded non-option derivative (i.e. the principal payment is determined based on a variable index that has the potential to increase and decrease) that are measured separately.

  When the instrument is recognized initially, the Committee agreed that the host debt component is measured at cost (i.e. the fair value of the consideration received for it), including transaction costs, and the embedded derivative is measured at zero. Subsequent to initial recognition, the Committee agreed that the host debt component is measured at amortised cost, and the embedded derivative is measured at fair value. The effect of the subsequent measurement is to measure the hybrid instrument at the amount of cash that would be delivered if the holder were to redeem the instrument.

  The SIC also considered the presentation of such instruments and the gain or loss arising from subsequent measurement. The Committee intends to include an appendix to the Draft Interpretation that illustrates an example of how such an enterprise might present such information.

  Further drafting revisions will be considered before the Draft Interpretation is submitted to a negative clearance process of the Board.