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**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: September 2006, London

Project: Adoption of IAS 38 (2004) (Agenda Paper 8(iv))

INTRODUCTION

1. In June 2006, the IFRIC received a request for guidance as to how certain consequential amendments made to IAS 38 should be accounted for on initial adoption. The consequential amendments were made to the standard at the time that IAS 16 was amended as part of the Improvements project in 2004.

DESCRIPTION OF THE ISSUE

2. Prior to 2004, an entity which had historically used IFRS to prepare its accounts would have accounted for intangible assets using IAS 38 (1998).
3. IAS 38.54 (1998) stated :

“The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use. The cost includes, if applicable:

- (a) expenditure on materials and services used or consumed in generating the intangible asset;
- (b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

- (c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate an asset; and
 - (d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of property, plant and equipment, insurance premiums and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see IAS 2 *Inventories*). IAS 23 *Borrowing Costs* establishes criteria for the recognition of interest as a component of the cost of an internally generated intangible asset.”
4. In December 2003, a revised version of IAS 16 was issued as part of the Improvements project. This revised version amended IAS 38.54¹ to read :
- “The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:
- (a) costs of materials and services used or consumed in generating the intangible asset;
 - (b) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising from the generation of the intangible asset;
 - (c) fees to register a legal right; and
 - (d) amortisation of patents and licences that are used to generate the intangible asset.
- IAS 23 *Borrowing Costs* specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.”
5. This change removed “overheads that are necessary to generate the asset” from the cost of an internally generated intangible asset. The question arises as to how an entity should account for this change in IAS 38.
6. IAS 16 (as amended by the Improvements project) was mandatory for periods ending after 1 January 2005 but early adoption was encouraged. The Improvements project did not amend the transitional requirements of IAS 38 and was silent as to the transitional requirements relating to changes to other standards.
7. The 2003 version of IAS 8 (paragraphs 46-48) deals with changes in accounting policies on adoption of international accounting standards. Paragraph 46 states that “In the absence of any transitional provisions, the change in accounting policies should be applied in accordance with the benchmark treatment...or the alternative treatment.” Both of these options would allow retrospective application.
8. In March 2004, IAS 38 was further amended during the issuance of IFRS 3. This did not make any changes to paragraph 54 as introduced by IAS 16. It did, however, amend the transitional arrangements of IAS 38 to state :

¹ IAS 38.66 in the current text

129 If an entity elects in accordance with paragraph 85 of IFRS 3 *Business Combinations* to apply IFRS 3 from any date before the effective dates set out in paragraphs 78–84 of IFRS 3, it also shall apply this Standard prospectively from that same date. Thus, the entity shall not adjust the carrying amount of intangible assets recognised at that date. However, the entity shall, at that date, apply this Standard to reassess the useful lives of its recognised intangible assets. If, as a result of that reassessment, the entity changes its assessment of the useful life of an asset, that change shall be accounted for as a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

130 Otherwise, an entity shall apply this Standard:

- (a) to the accounting for intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004; and
- (b) to the accounting for all other intangible assets prospectively from the beginning of the first annual period beginning on or after 31 March 2004. Thus, the entity shall not adjust the carrying amount of intangible assets recognised at that date. However, the entity shall, at that date, apply this Standard to reassess the useful lives of such intangible assets. If, as a result of that reassessment, the entity changes its assessment of the useful life of an asset, that change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

9. When the 2004 bound volume was produced, both the change to the costs which could be capitalised arising from the amendment to IAS 16 and the change to the transitional arrangements arising from IFRS 3 were incorporated in the revised IAS 38 (2004).
10. The issue raised with the IFRIC is whether the changes made to the transitional arrangements in IAS 38 by IFRS 3 requiring prospective application should be applied to the changes made to IAS 38.54² by the Improvements project or whether the changes made to IAS 38.54 may be applied retrospectively.

STAFF ANALYSIS

11. For a company adopting IFRS for the first time, the staff considers that the transitional arrangements included in IAS 38 are clear. The staff does not therefore expect divergence to emerge in companies applying IAS 38 for the first time after 2004.
12. In the case of entities which were applying IFRS in 2004, the staff considers that a number of options may have been used in preparing the 2004 financial statements including :

² IAS 34.66 in the current text

- deferring adoption of all of the changes and applying the transition provisions in the current version of the standard;
 - adopting the changes proposed by the Improvements project early and applying the changes made by IAS 16 retrospectively;
 - adopting the changes proposed by the Improvements project early along with the changes proposed by IFRS 3 and utilising the transition provisions requiring prospective adjustment.
13. To a certain extent, differing results may be obtained depending upon whether an entity chooses to adopt early or not. The staff considers that this is an accounting policy choice which is specifically allowed by the standard. Whilst this may lead to divergence, it is the result of a specific decision by the Board to allow early adoption and therefore the staff believes that this accounting policy choice is acceptable.
14. However, the staff considers that whether prospective or retrospective application is applied is a question of interpretation as to whether paragraphs 129-130 apply to the changes made by IAS 16. These differing interpretations are not a result of differing options within the standard, but rather differing interpretations of what the standard requires.
15. The staff considers that a strict reading of the current wording of the standard would imply that the amended transitional arrangements should be applied to IAS 38.66 (previously IAS 38.54). However, these revised transitional arrangements would not have existed between December 2003 and March 2004 and so could not have been applied by entities applying the standards at that time. If that is the case, then those entities would apply the changes retrospectively in accordance with IAS 8.
16. Furthermore, it may be argued that entities which adopted IAS 16 and the associated changes to IAS 38 early would apply the version of IAS 16 which existed without those transitional requirements. Again, if the transitional arrangements put in place by IFRS 3 did not exist, then entities would apply the changes made by IAS 16 retrospectively in line with IAS 8.

REASONS TO TAKE THE ISSUE ONTO THE AGENDA

Significantly divergent interpretations

17. The staff considers that the standards as currently written are clear. It is therefore unlikely that further divergence will develop in this area.
18. However, the staff considers that the requirements of the standards in and around 2004 may have been confusing to preparers. The successive changes in the requirements are likely to have resulted in some divergence in practice with some preparers applying the changes retrospectively and others applying them prospectively in line with the current transitional requirements of IAS 38.
19. Since any divergence is only likely to have occurred around a one-time event in 2004, the staff does not consider that divergence in this area is likely to be significant.

Practical and widespread relevance

20. As discussed above, since the standards as currently written are clear, the staff does not believe any guidance issued in this area is likely to have relevance to preparers other than those who interpreted the changing requirements of IAS 38 in 2004.
21. Since those preparers have already interpreted the guidance at that time in preparing their financial statements, and the change is a one off event, it is unlikely that any guidance developed will have any ongoing relevance.
22. The staff therefore considers that any guidance issued in this area is unlikely to have either practical or widespread relevance.

Likely to result in a consensus view of the IFRIC

23. There is no reason why the IFRIC should not reach a consensus view on the issue.

Relationship with a Board project

24. The issue is unrelated to a current Board project.

CONCLUSIONS

25. The staff believes that the timing of the amendments to IAS 38 and their incorporation in the bound volume is likely to have caused confusion as to how

the adoption of the changes in the definition of costs which may be capitalised as part of an intangible asset should be adopted.

26. The staff also believes that the current wording of the standard is clear so divergence is unlikely to exist in the case of new entities adopting IFRS for the first time.
27. Since the timescale over which confusion is likely to have existed is limited and in the past, and divergence is unlikely to increase due to the standards now being clear, the staff do not consider that the IFRIC should take the issue onto its agenda.
28. [Paragraph omitted from observer note, together with draft text for Tentative Agenda Decision].