Insights into IFRS

A practical guide to International Financial Reporting Standards

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Foreword

Change, confusion and chaos? Or comparability, confidence, and clarity? What will be the effect of adoption of International Financial Reporting Standards? At KPMG, our member firms' professionals around the globe have been working together to realise the benefits of adoption of a single set of accounting standards worldwide: enhanced comparability of financial statements to provide investors with improved confidence in reported results and reduced cost of funding to those accessing capital markets. We have been developing tools, investing in training, and working cooperatively to build IFRS resources in our firms around the world. This publication, *Insights into IFRS*, is one result of this work – a tool that we want to share both inside and outside of KPMG.

The challenge of change, and managing change, will continue beyond the initial adoption of IFRS. In a world where IFRSs are used widely, the challenge to us all – preparers, auditors and users of financial statements – will be to maintain and enhance the comparability that will deliver the benefits of IFRSs. The risk is that the comparability achieved initially will be eroded by differing interpretations, creating many dialects in which IFRSs are expressed. With that risk in mind, KPMG has developed this publication to focus on practical issues that arise when interpreting and applying IFRSs.

Like the standards on which it is based, *Insights into IFRS* is not a fixed document that, once printed, can be read and put aside. As business practices continue to evolve, and more and more cross-border comparisons are made, the standards and their interpretation will evolve. We all have a role to play in shaping that evolution, by participating fully in the standard-setting process of the International Accounting Standards Board, to help ensure that the Board's decisions are well-informed and can draw on the views of all of its constituents, and by applying the standards that exist with judgement and integrity. We at KPMG will continue to share our resources, experiences and views to update and enhance this publication. Our objective is to establish it as the first – and last – tool that you use to address your questions on IFRSs.

In closing, I'd like to thank all those within KPMG's member firms who made this publication possible, including current and former members of our International Financial Reporting Group and our IFRS Panel. These individuals, from KPMG member firms in over 20 countries, worked together to achieve a single goal. This exemplifies the kind of sharing of ideas and cooperative initiatives that IFRSs not only makes possible, but also demands. Our hope is that this publication helps us all to live up to this imperative.

Mike Rake
Chairman - KPMG International

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About this publication

Whether adopting IFRSs for the first time or "only" the many new and amended standards issued recently, the challenges of applying IFRSs have never been greater.

The greatest challenge may be interpreting the standards themselves and using judgement to apply IFRSs to real transactions and arrangements.

Insights into IFRS emphasises the application of standards in practice and explains the conclusions we have reached on many interpretative issues. While it includes an overview of the requirements of IFRSs, this publication is an interpretative guide to IFRSs that builds on those standards and should be read alongside them.

We have based *Insights into IFRS* on actual questions that have arisen in practice around the world. The guide includes many illustrative examples to elaborate or clarify the practical application of the standards.

Organisation of the text

The guide is organised into topics, following the typical presentation of items in financial statements. Separate sections deal with **general issues** such as business combinations, specific **balance sheet** and **income statement items** and with **special topics** such as leases. A separate section is focussed on issues relevant to those making the **transition to IFRSs**.

The overviews of the requirements of IFRSs and our interpretations of them are referenced to current IFRS literature. References in the left margin identify the relevant paragraphs of the standards or other literature (e.g., *IFRS 1.7*, being IFRS 1 paragraph 7).

The references in the left hand column are to the latest version of the standard that contains the requirement. When a requirement is not included in the latest version of the standard, for example, because it has been changed or deleted, the reference indicates in brackets the most recent version of the standard that *did* contain the requirement (e.g., IAS 27.13 (2000)).

Standard and interpretations

This publication is based on IFRSs issued at 1 August 2004. A list of these standards and interpretations is included in Appendix B.

When a significant change will occur as a result of a standard or interpretation that has been issued at 1 August 2004 but which is not yet required to be adopted, the impact of these **forthcoming requirements** is explained in accompanying boxed text. However, for ease of reference in the case of the sections that deal with financial instruments we have based the publication on the *latest* versions of the relevant standards (i.e., IAS 32 and IAS 39 as revised at 31 March 2004). The changes resulting from recent previous amendments to IAS 32 and IAS 39 are discussed in more detail in a separate KPMG publication *Financial Instruments Accounting* (March 2004).

When significant changes to IFRSs are anticipated, for example, as a result of an exposure draft or active project of the IASB, the possibility of **future developments** is noted in the text and the principal changes are discussed in a section at the end of each topic.

This guide is intended to cover general industries and transactions. It does not consider the requirements of IAS 26 *Accounting and Reporting by Retirement Benefit Plans* or IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

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Other ways KPMG can help

This publication has been produced by KPMG's International Financial Reporting Group. KPMG has a range of publications that can assist you further, in particular *Financial Instruments Accounting* (March 2004) and *Illustrative financial statements: First-time adoption in 2005* (available October 2004), a revised and updated addition to our series of Illustrative financial statements.

Alternatively, log on to KPMG's online resources. Current technical information and a briefing on KPMG's IFRS conversion support are available at www.kpmg.com/ifrs. For quick access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. With an emphasis on IFRSs and US GAAP, this Web-based subscription service can be a valuable tool for anyone that wants to stay current in today's dynamic regulatory environment. For a free 15 day trial, go to www.aro.kpmg.com and register today.

Interpretive guidance is based on specific facts and circumstances. In many instances, further interpretation will be needed in order for an entity to apply IFRSs to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on KPMG's International Financial Reporting Group's interpretations of IFRSs, which may change as practice and implementation guidance continue to develop. Users are cautioned to read this publication in conjunction with the actual text of the standards and implementation guidance issued, and to consult their professional advisers before concluding on accounting treatments for their own transactions.

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Acknowledgements

This publication was made possible by the invaluable input of many people working in KPMG member firms worldwide. The overview of the requirements of IFRSs and the interpretive positions described reflect the work of both current and former members of KPMG's International Financial Reporting Group (IFR Group) over the last six years. It also builds upon earlier guidance developed by member firms, for which the current authors are grateful.

The primary authors of the text were Kerry Nulty, Julie Santoro and Tara Smith, from KPMG member firms in Switzerland, Russia and South Africa, respectively; they were assisted by Lisa Busedu, Morten Friis and Sabine Löw, from KPMG member firms in the United States, Denmark and Germany. David Littleford, Erin McClung and Mary Tokar, all currently working with the IFR Group, were the primary editors of this edition. Current members of the IFR Group and a panel of reviewers composed of partners from KPMG member firms around the world generously contributed their time for exhaustive and challenging reviews. The thoughtful comments and wise counsel of David Knight, a former Vice-Chairman and retired partner of the Canadian member firm, were a final critical contribution.

A list of contributors from KPMG's IFR Group, including the panel of reviewers, is included inside the back cover of this publication.

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1. Background

1.1 Introduction

(IASC Foundation Constitution, Preface to IFRSs, IAS 1, IAS 8)

Overview

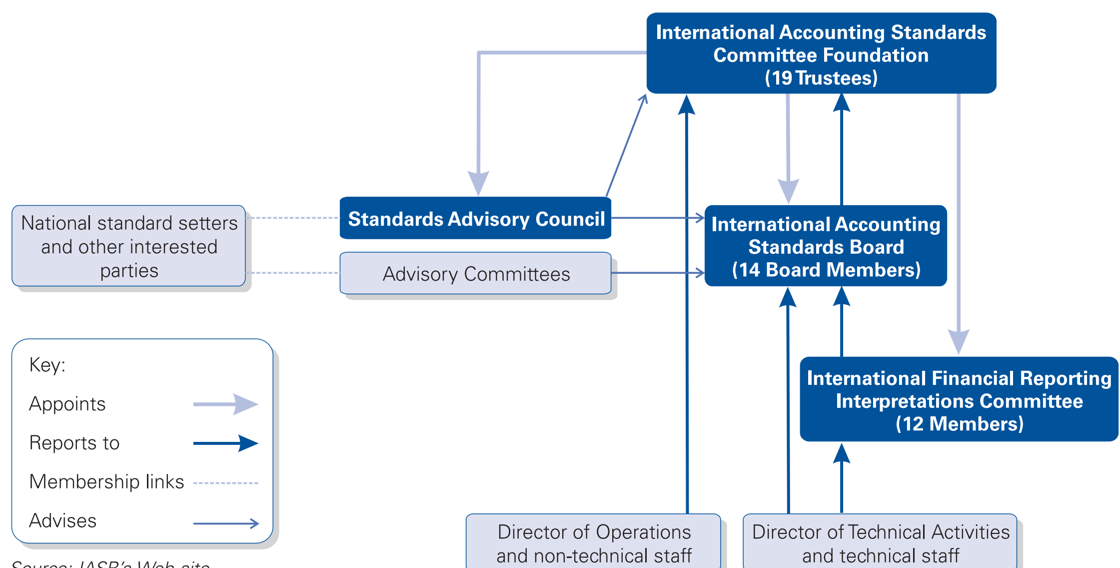
- **IFRSs is the term used to indicate the whole body of IASB authoritative literature.**
- **IFRSs are designed for use by profit-oriented entities.**
- **Any entity claiming compliance with IFRSs must comply with *all* standards and interpretations, including disclosure.**
- **Both the bold- and plain-type paragraphs of IFRSs have equal authority and must be complied with.**
- **The overriding requirement of IFRSs is for the financial statements to give a fair presentation (or true and fair view).**
- **A hierarchy of alternative sources is specified for situations when IFRSs do not cover a particular issue.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular:

- compliance with IFRSs, with additional disclosure when necessary, is presumed to result in a fair presentation; and
- compliance with a requirement of a standard or interpretation will be misleading when it conflicts with the objective of financial statements as set out in the Framework.

1.1.1 International Accounting Standards Board



Source: IASB's Web site

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Formation

The International Accounting Standards Board (IASB) started operations in April 2001 as the successor to the International Accounting Standards Committee (IASC). The IASB is the standard setting body of the International Accounting Standards Committee Foundation (IASC Foundation).

The objectives of the IASC Foundation, as stated in its constitution, are to:

- develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- promote the use and rigorous application of those standards; and
- bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

The stated objectives of the IASC Foundation may be subject to future developments (see 1.1.8).

Composition

The IASB comprises 12 full-time and two part-time members, appointed by the trustees of the IASC Foundation. The members come from a range of functional backgrounds and a number of the members also are responsible for formal liaison with national standard setters in order to promote the convergence of accounting standards. Although the selection of members is not based on geographical representation, the trustees must ensure that the IASB is not dominated by any particular geographical interest. Members are appointed for a term of up to five years, which is renewable once.

The composition of the IASB may be subject to future developments (see 1.1.8).

1.1.2 Standards Advisory Council

The Standards Advisory Council (SAC) comprises 48 organisations and individuals with an interest in international financial reporting. Members have a renewable term of up to three years. As stated in the IASC Foundation's constitution, the objectives of the SAC are to:

- give advice to the IASB on agenda decisions and priorities in the IASB's work;
- inform the IASB of the views of the members of the SAC on major standard-setting projects; and
- give other advice to the IASB or trustees.

The composition and objectives of the SAC may be subject to future developments (see 1.1.8).

1.1.3 International Financial Reporting Interpretations Committee

The International Financial Reporting Interpretations Committee (IFRIC), comprising 12 part-time members, was reconstituted in December 2001 as the successor to the Standing Interpretations Committee (SIC). IFRIC is responsible for providing interpretations of accounting issues that are likely to give rise to divergent or unacceptable treatments in the absence of authoritative guidance.

1.1.4 International Financial Reporting Standards

Definition

P.5 International Financial Reporting Standards (IFRSs) is the term used to indicate the whole body of IASB authoritative literature; it includes:

- IFRSs issued by the IASB;
- International Accounting Standards (IASs) issued by the IASC, or revisions thereof issued by the IASB;

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- Interpretations of IFRSs and IASs developed by IFRIC and approved for issue by the IASB; and
- SIC interpretations developed by the SIC and approved for issue by the IASB or IASC.

The term IFRSs is used in this publication to indicate any of the above material.

P.9 IFRSs are designed for use by profit-oriented entities. Entities in the public sector should refer to the International Public Sector Accounting Standards issued by IFAC, the International Federation of Accountants. Notwithstanding this, entities engaged in not-for-profit activities may find IFRSs useful, and may follow them if considered appropriate.

IFRSs are not limited to a particular legal framework. Therefore, financial statements prepared under IFRSs often contain supplementary information required by local statute or listing requirements.

Structure

P.14 IFRSs comprise a series of bold type- and plain type paragraphs. Generally the bold type paragraphs outline the main principle, and the plain type paragraphs provide further explanation. Both bold- and plain-type paragraphs have equal authority and must be complied with.

Some IFRSs contain appendices (e.g., IAS 7 *Cash Flow Statements*). A statement at the top of each appendix clarifies its status. Where an appendix is illustrative only and not an integral part of the standard, it does not have the same status as the standard itself. However, in our view, the guidance in an appendix should be followed except where it conflicts with the requirements of a standard or interpretation.

Benchmark versus allowed alternative

IFRSs sometimes include optional accounting treatments. These are referred to as a *benchmark* treatment and the *allowed alternative* treatment. The IASC rejected the use of the term 'preferred treatment' to describe either of the options and noted that the term 'benchmark' more closely reflects its intention of identifying a point of reference when making its choice between alternatives. In our view, where both treatments are consistent with the overriding requirement to give a fair presentation (or true and fair view, see 1.1.6), both treatments are equally acceptable. For each choice of accounting treatment an entity should apply the benchmark or allowed alternative consistently (see 2.4).

1.1.5 Compliance with IFRSs

IAS 1.11, 13, 14 Any entity claiming that a set of financial statements is in compliance with IFRSs must comply with *all* such standards and related interpretations. An entity cannot claim that its financial statements are, for example, "materially" in compliance with IFRSs, or that it has complied with "substantially all" requirements of IFRSs. Compliance with IFRSs encompasses disclosure as well as recognition and measurement requirements.

The IASB does not carry out any inquiry or enforcement role regarding the application of its standards. However, this often is undertaken by local regulators and / or stock exchanges.

1.1.6 A true and fair view

IAS 1.13 The overriding requirement of IFRSs is for the financial statements to give a fair presentation (or true and fair view)#.

Forthcoming requirements

IAS 1.13 The revised standard defines 'fair presentation' as the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses as set out in the Framework (see 1.2). It also clarifies that compliance with IFRSs, with additional disclosure when necessary, is presumed to result in a fair presentation.

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IAS 1.17-22 When compliance with a standard or interpretation would be misleading, an entity must depart from the required treatment in order to give a fair presentation#.

Forthcoming requirements

IAS 1.17-22 The revised standard clarifies that compliance with a requirement of a standard or interpretation will be misleading when it conflicts with the objective of financial statements as set out in the Framework (see 1.2). The entity should depart from the required treatment if the relevant regulator does not prohibit the override. If an override cannot be used because it is prohibited by the regulator, additional disclosure is required in the notes to the financial statements to reduce the perceived misleading impact of compliance to the maximum extent possible.

The use of a true and fair override is very rare under IFRSs and such a course of action should not be taken lightly. In the rare case of an override, extensive disclosures are required, including the particulars of the departure, the reasons for the departure and its effect.

1.1.7 Hierarchy

IAS 1.22 (1997) When IFRSs do not cover a particular issue, the entity should consider#:

- other IFRSs dealing with similar and related issues;
- the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework); and
- to the extent that they do not conflict with the above, pronouncements of other standard setting bodies (e.g., the US Financial Accounting Standards Board) and accepted industry practice.

This hierarchy of accounting literature provides entities with a basic structure for resolving issues in the absence of specific guidance.

Forthcoming requirements

IAS 8.11, 12 The revised standard modifies the hierarchy to reduce the need to refer to the pronouncements of other standard setting bodies. When IFRSs do not cover a particular issue, the entity should consider:

- the guidance and requirements in standards and interpretations dealing with similar and related issues; and
- the conceptual framework of the IASB, *Framework for the Preparation and Presentation of Financial Statements* (the Framework).

The entity may also consider pronouncements of other standard setting bodies (e.g., the US Financial Accounting Standards Board) and accepted industry practice, to the extent that they do not conflict with the standards, interpretations and the Framework referred to above.

1.1.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In November 2003, the trustees of the IASC Foundation began a review of its constitution. The review has yet to be completed and may result in changes to the constitution, including in respect of the objectives of the Foundation, the composition of the IASB and SAC and the objectives of the SAC.

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1.2 The Framework

(IASB Framework)

Overview

- **The IASB uses its conceptual framework as an aid to drafting new or revised IFRSs.**
- **The Framework is a key point of reference for preparers of financial statements in the absence of specific guidance.**
- **IFRSs do not apply to items that are "immaterial".**
- **Transactions should be accounted for in accordance with their substance, rather than only their legal form.**
- **Transactions with shareholders should be considered carefully in determining the appropriate accounting.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1, *Presentation of Financial Statements* and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text.

1.2.1 Introduction

The IASB's conceptual framework, the Framework, provides a broad discussion of the basis of preparing financial statements. It discusses their objectives, underlying assumptions and qualitative characteristics (such as relevance and reliability); and perhaps more importantly, it discusses assets, liabilities, income and expenses, providing definitions and recognition criteria. Finally, the Framework discusses the measurement of assets and liabilities in broad terms and the concepts of capital and capital maintenance.

The IASB uses the Framework as an aid to drafting new or revised IFRSs. The Framework also provides a point of reference for preparers of financial statements in the absence of any specific standards on a particular subject (see 1.1); the purpose of this section is to highlight some of the key principles to be aware of.

1.2.2 Assets and liabilities

Definitions

F.49 In developing new standards and interpretations, the IASB relies on the following definitions of assets and liabilities, which are a key element of the Framework:

- An asset is a resource controlled by the entity as a result of past events, from which future economic benefits are expected to flow to the entity.
- A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

F.49, 70 The definitions of equity, income and expenses all derive from the definitions of assets and liabilities:

- Equity is the residual interest in the assets of the entity after deducting all of its liabilities.
- Income is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

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- Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The Framework's emphasis on assets and liabilities, and the resulting influence that this has had on standard setting in general, means that any entity analysing how a transaction should be accounted for should bear in mind this balance sheet orientation.

Recognition criteria

F.83 An item that meets the definition of an asset or liability is recognised when:

- it is probable that any future economic benefit associated with the item will flow to (asset) or from (liability) the entity; and
- the asset or liability has a cost or value that can be measured reliably.

IAS 37.23 The term "probable" is not defined in the Framework and, except in respect of the recognition of provisions (see 3.11), neither is it defined in any IFRSs. One interpretation of "probable", which is consistent with provisioning, is "more likely than not". However, higher thresholds cannot be ruled out.

IAS 37.28, 34 Where the above criteria are not met, disclosure of the (potential) asset or liability may nonetheless be required under the requirements for contingent assets and liabilities (see 3.13).

Matching

F.95 A common desire in preparing financial statements is to match revenues and expenses. While matching historically has had a significant influence on the preparation of financial statements, it has been de-emphasised in recent standard setting as the predominance of the balance sheet approach has grown. Accordingly expenses (or revenues) may be deferred in the balance sheet only if they meet the definition of an asset (or liability).

For example, a football club may spend five months of the year incurring maintenance expenditure to prepare the grounds for the oncoming season. If the expense could be deferred and recognised at the same time as the revenue from ticket sales, the entity might avoid showing a loss in the income statement during those five months and significant profits later. However, notwithstanding the uneven impact on the income statement, the maintenance expenditure would be expensed as incurred.

Executory contracts

IAS 37.3 Although the Framework does not refer explicitly to executory contracts, they are an integral part of accounting under IFRSs. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* describes an executory contract as one in which "neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent". For example, an entity enters into a contract to buy equipment in six months and agrees to pay 100,000 at that time. This is an executory contract because the entity has the right to receive the equipment, but also has an obligation to pay the 100,000, and neither party has performed its obligations.

IAS 37.66 Even though the rights and obligations under executory contracts generally meet the definition and recognition criteria of assets and liabilities, current practice generally is not to record them in the financial statements to the extent that the rights and obligations have equal value, or the rights have a value greater than the obligations. Where the value of the obligations exceeds the value of the rights, a provision for an onerous contract is recognised in accordance with IAS 37 (see 3.11).

1.2.3 Relevance versus reliability

F.26, 31 Two of the qualitative characteristics of financial statements are relevance and reliability. Information is relevant if it assists users in making economic decisions, or assessing past evaluations; information is reliable if it represents faithfully what it purports to represent.

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In many cases there is a trade-off between the relevance and reliability of information. For example, knowing the fair value of an asset often is more relevant to users than historical cost; however, the measurement of historical cost is much more reliable because it is based on an actual transaction to which the entity was a party and therefore accurate information is available. In many cases IFRSs favour relevance over perfect reliability, and the use of fair values in preparing financial statements is growing (see 2.4).

1.2.4 Materiality

F.29, 30

IFRSs do not apply to items that are "immaterial". The term is not defined explicitly, but the Framework explains that "information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements". Accordingly, materiality depends on the facts and circumstances of a particular case, and both the size and nature of an item is relevant.

Forthcoming requirements

IAS 1.11, 8.5

Materiality is defined by illustration. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. Either the size or the nature of the item, or a combination of both, could be the determining factor. Consideration of materiality is relevant to judgements regarding both the selection and application of accounting policies and to the omission or disclosure of information in the financial statements.

IAS 1.30, 31, 84

Materiality is a factor when making judgements about disclosure. For example, materiality impacts when items may be aggregated, the use of additional line items, headings and sub-totals. Materiality also is relevant to the positioning of these disclosures – an item may be sufficiently material to warrant disclosure on the face of the financial statements or may only require disclosure in the notes to the financial statements. Materiality may mean that a specific disclosure requirement in a standard or an interpretation is not applicable if the information is not material.

IAS 8.8

Accounting policies selected in accordance with IFRSs do not need to be applied when their effect is immaterial.

IAS 8.41

Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors that are made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

1.2.5 Prudence

F.37

In preparing financial statements there may be a tendency to put greater emphasis on the possible negative outcomes of transactions and events rather than the possible positive outcomes. This could lead to a loss of neutrality and to the understatement of profit. The Framework makes it clear that prudence means exercising a degree of caution in making judgements under conditions of uncertainty, but that it should not lead to the creation of hidden reserves or excessive provisions.

1.2.6 Substance over form

F.35

The Framework establishes a general requirement to account for transactions in accordance with their substance, rather than only their legal form. This principle comes through clearly in many IFRSs. For example, revenue from the sale of goods is not recognised automatically at the stated effective date of a contract unless the significant risks and rewards of ownership of the goods have been transferred to the buyer (see 4.2).

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1.2.7 Transactions with shareholders

F.70 The definitions of income and expenses exclude capital transactions with equity participants. Thus, for example, capital contributions from shareholders are recorded directly in equity, as are dividends paid to shareholders. However, the position is less clear where the transaction with the shareholder equally could have been with a third party.

For example, an entity sells inventory at fair value to a shareholder. In this case the transaction should be recorded in the income statement because the shareholder is not acting in its capacity as a shareholder; rather, it is transacting with the entity in the same way as any other third party.

But suppose the inventory is given without consideration to a shareholder. In this case it can be argued that the shareholder has received a benefit from the entity in its capacity as a shareholder because an independent third party would not have received the inventory for free. In our view, and in the absence of any other pertinent facts, this transaction should be recorded directly in equity as a distribution to shareholders (see 3.10).

In a third example, suppose the shareholder pays considerably more than fair value for the inventory. In our view, such a transaction generally should be split into a capital transaction and a revenue transaction. Proceeds equal to the fair value of the inventory would be recorded in the income statement, with the remaining proceeds being recorded directly in equity as a contribution from shareholders.

The key point is that transactions with shareholders should be considered carefully, having regard to all the facts and circumstances, in determining the appropriate accounting.

1.2.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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2. General issues

2.1 Form and elements of financial statements

(IAS 1, IAS 27)

Overview

- **The following must be presented: balance sheet; income statement; statement of changes in equity or a statement of recognised gains and losses; statement of cash flows; notes, including accounting policies.**
- **While IFRSs specify minimum disclosures to be made in the financial statements, they do not require prescriptive formats.**
- **Comparative information is required for the preceding period only, but additional periods and information may be presented.**
- **An entity must present consolidated financial statements unless certain strict criteria are met.**
- **There is no requirement to present the parent entity financial statements in addition to consolidated financial statements, although this is permitted.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements,* IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text.

2.1.1 Elements of the financial statements

IAS 1.8 The following must be presented:

- balance sheet (see 3.1);
- income statement (see 4.1);
- statement of all changes in equity (see 2.2 and 3.10), or a statement of recognised gains and losses (see 2.2);
- statement of cash flows (see 2.3); and
- notes to the financial statements, including accounting policies.

While IFRSs specify minimum disclosures to be made in the financial statements, they do not require prescriptive formats to be followed. In practice entities consider the presentation adopted by other entities in the same industry.

IAS 1.69, 81-83 Although IAS 1 requires a number of disclosures to be made on the face of the primary statements, generally IFRSs allow significant flexibility in presenting additional line items and sub-totals where necessary to ensure a fair presentation (see 4.1 and 4.8). In addition to the information required to be disclosed in the financial statements, many entities provide additional information outside of the financial statements, either because of local regulations or stock exchange requirements or voluntarily (see 5.8).

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2.1.2 Reporting period

IAS 1.49

Financial statements are presented for the period ending on the balance sheet date. The balance sheet date may change only in "exceptional circumstances" (e.g., following a change of major shareholder). If the balance sheet date does change, it follows that the financial statements for that period will cover either more or less than 12 months, in which case full disclosure of that fact is required. In such cases comparative information is not adjusted. However, *pro forma* information for the comparable preceding reporting period might be presented (see 2.1.3).

IAS 1.52 (2000)

IAS 1 states that an entity should be able to present financial statements within six months of its reporting date#. However, in practice little attention is paid to this suggestion. While we support the preparation of financial statements as soon as possible after the balance sheet date, in our view, the "should" in this context does not mean "must", since the timing of the release of information generally is a local regulatory matter.

Forthcoming requirements

IAS 1

The six month reporting time frame described above has been deleted by the IASB as part of the revisions to IAS 1.

2.1.3 Comparative information

IAS 1.36

Comparative information is required for the preceding period. Unless there is a specific exemption provided in a standard (or an interpretation), all of the previous period's numerical information (amounts) must be presented as part of the comparatives. Generally, the related narrative and descriptive information is required when relevant for an understanding of the current period's financial statements. So, for example, comparative segment information generally would be disclosed.

IAS 1 does not require a particular format for the presentation of comparatives. Most entities reporting under IFRSs provide comparative figures, whereby information about the previous reporting period is presented alongside that for the current period.

IFRS 1.36, 37

If an entity wants to, or if required by a regulator or stock exchange, more extensive comparatives may be presented. When an entity is adopting IFRSs for the first time, comparatives required by IFRSs must be prepared in accordance with IFRSs. However, any additional comparatives included in the financial statements need not comply with IFRSs provided that those comparatives are labelled clearly and that certain explanatory disclosures are included (see section 6).

2.1.4 Consolidated financial statements

IAS 27.8 (2000)

IFRSs identify the circumstances in which an entity is exempted from preparing consolidated financial statements. An entity must present consolidated financial statements unless it is a wholly owned subsidiary; or it is a virtually wholly owned subsidiary (normally 90 per cent or more) and it obtains the approval of the owners of the minority interest#.

Forthcoming requirements

IAS 27.10

The revised standard modifies the scope of exemptions from preparing consolidated financial statements and the following criteria must be met:

- the parent is itself a wholly owned subsidiary, or is a partially owned subsidiary and other owners (including those not otherwise entitled to vote), have been informed and they do not object to the parent not preparing consolidated financial statements;
- the parent's debt or equity instruments are not traded in a public market;
- the parent did not file, and is not in the process of filing, its financial statements with a regulatory organisation for the purpose of issuing any class of instruments in a public market; and
- the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs.

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IAS 27 requires the following disclosures for an entity meeting and using the criteria for exemption from preparing consolidated financial statements:

- the reasons why consolidated financial statements have not been presented;
- the bases on which subsidiaries are accounted for in its separate financial statements; and
- the name and registered office of its parent that publishes consolidated financial statements#.

Forthcoming requirements

IAS 27.41 Under the revised standard, more disclosures are required when an entity prepares separate financial statements under the above exemption. These include the fact that financial statements are separate financial statements; that the exemption from consolidation has been used; the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with IFRSs have been produced for public use; and the address where those consolidated financial statements are obtainable. An entity also is required to provide a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and the description of the method used to account for its investments.

In our view, the standard should be interpreted as requiring an entity to prepare consolidated financial statements unless#:

a) the entity is:
   i) a wholly owned subsidiary; or
   ii) a virtually wholly owned subsidiary (normally 90 per cent or more) and it obtains the approval of the owners of the minority interest; and
b) the entity's parent (either an intermediate or the top-level parent) prepares consolidated financial statements in accordance with IFRSs that are made available to the users of the entity's financial statements.

IAS 27.41 Our view that the entity's parent must prepare consolidated financial statements is drawn from the requirement to disclose the name and registered office of the parent that publishes consolidated financial statements.

IAS 27.8 (2000) In addition, we believe that "publishes" means that the consolidated financial statements are "made available to" users of the entity's financial statements, either because they are released publicly or made available upon request. Further, our view that the consolidated financial statements must comply with IFRSs is drawn from the statement in IAS 27 that consolidated financial statements are prepared in accordance with IFRSs.

Forthcoming requirements

IAS 27.10 Under the revised standard, all of the criteria mentioned above have to be satisfied to qualify for exemption from preparing consolidated financial statements.

IAS 27.41 The revised standard clarifies that financial statements should be available for public use.

If an entity does not qualify for the above exemption, but nonetheless decides to present only individual entity financial statements, we do not believe that these individual financial statements can be regarded as complying with IFRSs (see 1.1). Our view is based on the fact that the preparation of consolidated financial statements is fundamental to compliance with IFRSs and pervades every aspect of the financial statements.

In some cases an entity may qualify for the exemption except for the fact that the consolidated financial statements for the period have not yet been prepared by its parent. In such cases our view

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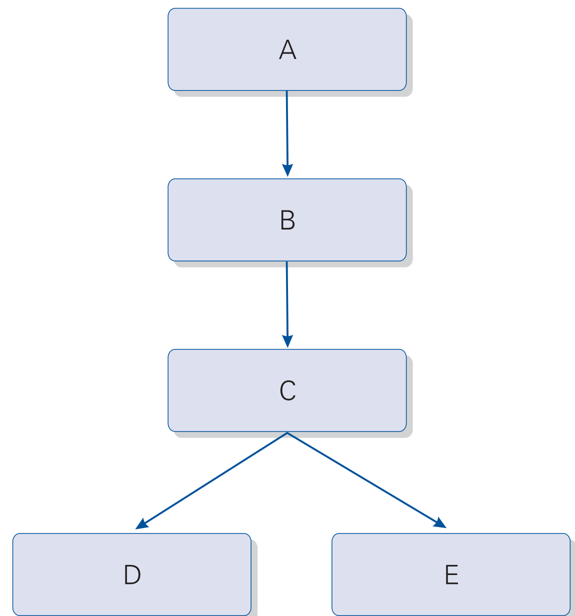
is that the criteria are met if there are reasonable grounds to believe that the parent will prepare consolidated financial statements in accordance with IFRSs and these will be made available to users of the entity's financial statements. An example of "reasonable grounds" is a well established practice by the parent of preparing consolidated financial statements in accordance with IFRSs, and there is no reason to believe that this practice will change.

In this example, which highlights our view, B is an intermediate parent owned 100 per cent by A, the ultimate parent.



C is not required to prepare consolidated financial statements when:

- C's financial statements contain the required disclosures (see above); and either:
  - B prepares consolidated financial statements in accordance with IFRSs; or
  - when B meets the exemption criteria, A prepares consolidated financial statements in accordance with IFRSs; and
- the consolidated financial statements of either B or A, as the case may be, are available to the users of the financial statements of C.

2.1.5 Parent only financial statements

Frequently only consolidated financial statements are presented as IFRSs do not contain a requirement to present the parent entity's unconsolidated financial statements. However, if parent entity (i.e., unconsolidated) financial statements are prepared in accordance with IFRSs, all relevant standards would apply equally to these individual financial statements. Some standards include special alternatives for the preparation of parent entity financial statements, which are addressed throughout this publication to the extent that interpretive questions have arisen.

2.1.6 Presentation of *pro forma* information

Except in relation to a change in accounting policy (see 2.8), IFRSs are silent on the presentation of *pro forma* information within the financial statements. For example, following an acquisition an entity might want to disclose a *pro forma* income statement as if the acquisition had occurred at the beginning of the reporting period. Generally, such presentation is acceptable to the extent that it is allowed by local regulations and relevant stock exchange rules, and provided that:

- the information is labelled clearly to distinguish it from the financial statements prepared in accordance with IFRSs, and is marked clearly as unaudited if that is the case;
- the transaction or event that is reflected in the *pro forma* financial information is described, as well as the source of the financial information on which it is based, the significant assumptions used in developing the *pro forma* adjustments, and any significant uncertainties about those adjustments; and
- the presentation indicates that the *pro forma* financial information should be read in conjunction with the financial statements and that the *pro forma* financial information is not necessarily indicative of the results that would have been attained if, for example, the transaction or event had taken place earlier.

See section 5.8 for further guidance.

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2.1.7 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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2.2 Statement of changes in equity

(IAS 1, IAS 8)

Overview

- **There is a choice of presenting as a primary statement either a statement of recognised gains and losses or a statement of total changes in equity.**
- **The statement of recognised gains and losses combines net profit or loss with all other non-owner movements recognised directly in equity.**
- **A gain or loss may be recognised directly in equity only when a standard permits or requires it.**
- **The cumulative effect of changes in accounting policy and the correction of fundamental errors must be disclosed on the face of the statement, when accounted for retrospectively.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text.

2.2.1 Recognised gains and losses, or changes in equity

IAS 1.96, 97 A statement of changes in equity is presented as a primary statement. The statement must include all recognised gains and losses, including those recognised directly in equity (see 2.2.2) and the cumulative effect of changes in accounting policy and the correction of errors (see 2.8)#.

The statement may be expanded to be a reconciliation of opening and closing equity. When this approach is adopted the statement will include also the amounts of transactions with equity holders acting in their capacity as equity holders (see 3.10). Alternatively, such a reconciliation may be presented in the notes to the financial statements. In practice both presentations are used and no preference has become the predominant practice. A statement that excludes transactions with owners and therefore does not provide a reconciliation of opening and closing equity can be described as a statement of recognised gains and losses (see 2.2.6).

Forthcoming requirements

IAS 1.96(c) The revised standard requires that the statement also include a sub-total of all income and expenses for the period; this sub-total is the total of the profit and loss for the period and any amounts recognised directly in equity. The total amounts attributable to equity holders of the parent and minority interest must be shown separately.

This area of IFRSs may be subject to future developments (see 2.2.6).

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The following is an example statement:

Consolidated statement of recognised gains and losses
For the year ended 31 December 2004

In thousands of euro	*2004*	*2003*
Foreign exchange translation differences	(253)	(99)
Net gain / (loss) on hedge of net investment in a foreign subsidiary	3	(8)
Revaluation of property, plant and equipment before transfer to investment property	170	-
Cash flow hedges:		
Effective portion of changes in fair value	129	-
Transferred to the income statement	(139)	-
Recognised in cost of inventory	(41)	-
Net loss recognised directly in equity	(131)	(107)
Net profit for the year	6,844	3,852
Total recognised income and expense	6,713	3,745

The disclosure of the effect of changes in accounting policy at the bottom of the statement is explained under 2.2.4.

2.2.2 Recognition directly in equity

IAS 1.78, F 65

In accordance with IAS 1 a gain or loss is recognised directly in equity only when a standard (or interpretation) permits or requires it; examples include the revaluation of property, plant and equipment (see 3.2) and of intangible assets (see 3.3), foreign exchange differences on the translation of foreign entities (see 2.7) and the effects of cash flow hedging (see 3.6). Unless recognition directly in equity is permitted specifically by a standard, the gain or loss must be recorded in the income statement.

2.2.3 Effect of income tax

IAS 12.61

Generally, income tax (current and deferred) should be recognised directly in equity if the related gain or loss is recognised directly in equity. There is no requirement to disclose this tax separately on the face of the statement, and typically in practice this is not done. Instead, the tax generally is disclosed in the notes to the financial statements (see 3.12).

2.2.4 Changes in accounting policy and fundamental errors

IAS 8.31-57 (1993)

A change in accounting policy or the correction of a fundamental error may be presented either by adjusting the opening balance of retained earnings of the earliest period presented and restating comparatives (the benchmark treatment) or by including the cumulative adjustment in the income statement for the current period (the allowed alternative treatment)#; these are discussed further in 2.8.

Forthcoming requirements

IAS 8

The revised IAS 8 removes the distinction between fundamental errors and other material errors.

The revised standard also removes the allowed alternative method of recognising the cumulative effect of changes in accounting policies and correction of errors in the current period. Voluntary changes in accounting policies and corrections of errors must be accounted for retrospectively.

In respect of the benchmark treatment, issues arise as to how the effect of a change in accounting policy or the correction of a fundamental error should be presented when the entity elects to

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present a statement of recognised gains and losses as a separate statement. These issues are illustrated using the following example:

In 2002, an entity changes its accounting policy from expensing borrowing costs as incurred to capitalising borrowing costs in respect of qualifying assets (see 4.6). The change in accounting policy is accounted for by adjusting the opening balance of retained earnings and restating comparatives (i.e., the benchmark treatment). The impact on retained earnings for periods prior to 2001 is an increase of 9,000; the impact on net profit in 2001 is an increase of 200,000; and the impact on net profit for 2002 is an increase of 723,000.

Disclosure of the effect

IAS 1.79, 1.96(d), 8.22, 23

When the benchmark treatment is used to report a change in accounting policy or correction of a fundamental error, IAS 8 requires presentation of the effect on retained earnings for not only the current period but also for any comparative periods. The interaction of the requirements for application of the benchmark treatment for changes in accounting policy and corrections of fundamental errors with the presentation of a statement of recognised gains and losses is unclear.

In our view, the change in accounting policy is a current year item whose measurement includes elements relating to both the comparative period profit and loss and to opening retained earnings of the comparative period. Under this view, the statement of recognised gains and losses for 2002 would report 209,000 as the effect of a change in accounting policy.

While several different presentations have been used in practice, we prefer to have the effect of a change in accounting policy or correction of a fundamental error accounted for using the benchmark treatment presented in the statement of recognised gains and losses as a current year item only. Following the above example, in 2002 an amount of 209,000 will be disclosed as the cumulative effect of a change in accounting policy on the face of the statement of recognised gains and losses. No amount would be shown for 2001, although 2001's previously reported net profit or loss should be restated (and labelled as restated).

IAS 1.96, 97, 8.161

We do not believe that requirements to present separately an analysis of the impact of a change on opening retained earnings split between opening retained earnings of the comparative period, and the cumulative effect on opening retained earnings of the current period, applies to the statement of recognised gains and losses. IFRSs permit the requirement for a statement of total recognised gains and losses to be satisfied by combining the statement of movements in equity with the net profit or loss and other items recognised directly in equity. However, to repeat the split presentation of the impact of the change on retained earnings illustrated in the implementation guidance for IAS 8 would include the impact of restatement of the comparative period (both retained earnings and profit and loss) as both a 2001 and 2002 item. We believe that the statement of recognised gains and losses requires identification of events with a single period.

Note that when a change in accounting policy or the correction of a fundamental error is accounted for using the allowed alternative treatment of recognising the cumulative effect in the current period, the disclosure of the impact on each of opening retained earnings and comparative period retained earnings is not required#.

Forthcoming requirements

IAS 8

The revised IAS 8 removes the distinction between fundamental errors and other material errors.

The revised standard also removes the allowed alternative method of recognising the cumulative effect of changes in accounting policies and correction of errors in the current period. Voluntary changes in accounting policies and corrections of errors must be accounted for retrospectively.

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2.2.5 No gains or losses other than net profit or loss

In some cases an entity may have nothing to report in the statement of recognised gains and losses other than the net profit or loss from the income statement. In our view, it is not necessary to present a statement if this is the case for both the current and comparative reporting periods. Instead, the entity may disclose at the foot of the income statement that there were no gains or losses for the current or comparative periods other than those reported in the income statement.

2.2.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

As part of its project on reporting performance, the IASB intends to propose a single statement of comprehensive income, which would replace the income statement and statement of changes in equity (see 4.1).

In April 2004, the IASB issued an Exposure Draft *Actuarial Gains and Losses, Group Plans and Disclosures* of proposed amendments to IAS 19 *Employee Benefits*. That exposure draft proposes that a statement that excludes transactions with owners and therefore does not provide a reconciliation of opening and closing equity must be described as a *statement of recognised income or expense*.

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2.3 Statement of cash flows

(IAS 7)

Overview

- **The cash flow statement presents cash flows during the period classified by operating, investing and financing activities.**
- **Net cash flows from all three categories are totalled to show the change in cash and cash equivalents during the period, which then is used to reconcile opening and closing cash and cash equivalents.**
- **Cash flows from operating activities may be presented either by the direct method or the indirect method.**
- **Foreign currency cash flows are translated at the exchange rate at the date of the cash flow (or using averages when appropriate).**
- **Generally all financing and investing cash flows should be reported gross, without applying offset.**

2.3.1 Cash and cash equivalents

IAS 7.6 Cash comprises cash on hand and demand deposits. Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

Demand deposits are not defined in IAS 7, but in our view they should have the same level of liquidity as cash, and therefore should be able to be withdrawn at any time without penalty. There is no requirement in IAS 7 for demand deposits to be held with a financial institution, and in our view this is not necessary. If a deposit fails to be classified as cash it still may meet the definition of cash equivalents.

Since the investments comprising cash equivalents must be readily convertible to known amounts of cash, in our view only debt securities and deposits can qualify for inclusion, subject to the other criteria being met. "Short-term" is not defined, but the standard encourages a cut-off of three months' maturity (from the date of acquisition). In our view, three months should be used as an absolute cut-off, and debt securities with a longer maturity should be regarded as part of investing activities. Investments with a longer maturity at acquisition do not become cash equivalents once their remaining maturity period falls to three months.

IAS 7.7 In practice much emphasis is placed on the above definitions. However, an overriding test is that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For example, an entity gives a three-month loan to a customer to assist the customer in managing its short-term liquidity position; in our view, this loan is not a cash equivalent because it was given for a purpose other than for the entity to manage its own short-term cash commitments.

IAS 7.8, 32.42 Bank overdrafts repayable on demand are included as cash and cash equivalents if and when they form an integral part of the entity's cash management. However, even though a bank overdraft might be netted against cash and cash equivalents for purposes of the cash flow statement, this is not permitted on the face of the balance sheet unless the offsetting criteria are met (see 3.1 and 5.6).

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2.3.2 Operating, investing and financing activities

IAS 7.6, 10 The cash flow statement presents cash flows during the period classified by operating, investing and financing activities. Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Investing activities relate to long-term assets and other investments not included in cash equivalents. Financing activities relate to shareholders' equity and borrowings of the entity. The wording of the definitions means that operating activities is the default classification when a cash flow does not meet the definition of either investing or financing cash flows.

IAS 7.12 The separate components of a single transaction each should be classified as operating, investing or financing; IAS 7 does not allow a transaction to be classified based on its predominant characteristic. For example, a loan repayment comprises interest (which may be classified as operating or financing – see 2.3.4) and principal repayment (which will be classified as financing).

IAS 7.39-42 However, when subsidiaries or other business units are either acquired or disposed or, the aggregate net cash flows from the acquisition or disposal transaction are presented separately as a single line item as part of investing activities. For example, when a subsidiary is acquired, a single line item equal to the cash paid, less any cash or cash equivalents held by the subsidiary at the time of acquisition, is shown as an investing cash outflow, rather than showing separate cash outflows and inflows for all the various net assets and liabilities acquired.

IAS 7.43 Non-cash investing or financing transactions (e.g., shares issued as consideration in a business combination) are not included in the statement of cash flows, but must be disclosed in order to provide relevant information about investing and financing activities.

2.3.3 Direct versus indirect method

IAS 7.18, 19 Cash flows from operating activities may be presented either by the direct method (receipts from customers, payments to suppliers, etc.) or by the indirect method (net profit or loss for the period reconciled to the total net cash flow from operating activities). Although the standard encourages use of the direct method, in our experience the indirect method usually is used.

IAS 7.18, 7.A For an entity that elects to present operating cash flows using the indirect method, there often is confusion about the correct starting point: should it be profit or loss (i.e., the final figure in the income statement) or can a different figure, such as profit before tax, be used? The standard itself refers to the profit or loss, but the appendix to IAS 7 starts with a different figure (i.e., profit before taxation). Our preference is to follow the standard since the appendix is illustrative only and therefore does not have the same status (see 1.1).

Alternatively, if an entity uses the indirect method, it instead may choose to present its operating cash flows by showing revenues and expenses before working capital changes as the starting point, followed by changes during the period in inventories, and operating receivables and payables (as illustrated in Appendix A to IAS 7). However, in our experience, this approach is less common.

2.3.4 Some classification issues

Interest, dividends and taxes

IAS 7.31, 35 IAS 7 requires cash flows from interest and dividends received and paid, and income taxes paid, to be disclosed separately. In our view, this means that disclosure is required on the face of the cash flow statement rather than in the notes.

IAS 7.31, 35, 36 The standard does not, however, specify the classification of such cash flows, and an entity is required to choose its own policy for classifying each of interest and dividends paid as operating or financing activities and each of interest and dividends received as operating or investing activities. The presentation should be selected to present these cash flows in a manner which is most appropriate to its business; the method selected should be applied consistently. Taxes paid should be

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classified as operating activities unless it is practicable to identify them with, and therefore classify them as, financing or investing activities.

With regard to the presentation of taxes paid, if an entity wants to classify certain taxes as investing or financing activities, the standard is not clear as to whether *all* taxes paid must be allocated among the three categories of cash flows, or whether it is acceptable to allocate only certain taxes paid because they relate to transactions classified as investing or financing (leaving the balance in operating activities). In our view, it is acceptable to allocate only certain material tax cash flows, while leaving the balance in operating activities, as long as the approach taken is applied consistently and disclosed properly. We believe that allocating, for example, 60 per cent of the tax cash flows, with appropriate disclosure, provides better information that not allocating any.

IAS 7.12 In our view, to the extent that borrowing costs are capitalised in respect of qualifying assets (see 4.6), the cost of acquiring those assets should be split in the cash flow statement. For example, an entity constructs an asset and pays construction expenses of 1,000, which includes 50 of capitalised interest. In such circumstances, the interest paid of 50 will be included in operating or financing activities (depending on the entity's accounting policy), and the remaining 950 will be included in investing activities.

This is consistent with the IAS 7 requirement to classify separately the different components of a single transaction (see above).

Hedging

IAS 7.16 When a hedging instrument is accounted for as a hedge of an identifiable position (see 3.6), the cash flows of the hedging instrument are classified in the same manner as the cash flows of the position being hedged. This is an exception to the principle that the different components of a single transaction should be classified separately.

For example, an entity takes out a forward contract, which is fully effective in hedging the acquisition of an item of property, plant and equipment. At settlement date the forward contract expires and the entity pays for the asset. The cost of the asset at the spot exchange rate is 155, which is offset by a gain on the forward contract of 5. In the cash flow statement the entity discloses 150 for the acquisition of property, plant and equipment.

Continuing the above example, if the forward contract matured at the end of 2002, but the asset was paid for in early 2003, the cash flow arising from the forward contract would be disclosed as an investing cash flow in 2002 – the direct payment for the acquisition of the asset would not be reflected in the cash flow statement until 2003. In addition, if the forward contract is not a perfect hedge, in our view only the effective portion of the hedge should be classified as investing activities for the acquisition of property, plant and equipment with any ineffective portion shown within operating activities; this is consistent with the application of IAS 39 in respect of the carrying amount in the balance sheet.

For a hedge of a net investment in a subsidiary that is a foreign entity (see 3.6), the appropriate classification of the cash flows from hedging is not clear because the operations of the subsidiary are consolidated and therefore affect all lines of the cash flow statement. In our view, it is preferable for the cash flows from the hedging activity to be classified as operating activities because, from a consolidated point of view, they are neither investing nor financing activities.

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Securitisation of receivables

IAS 7 does not refer to securitisations, but in our view, the classification of the proceeds from a securitisation of receivables should follow the underlying accounting (see 3.6):

- If the receivables are not derecognised and the proceeds are recognised as a liability, the proceeds should be classified as part of financing activities.
- If the receivables are derecognised, our preference is for the proceeds to be classified as part of operating activities even if the entity does not enter into such transactions regularly. This is because we believe that the proceeds do not fit clearly into the definitions of either investing or financing activities (see 2.3.2); also, a securitisation resulting in derecognition is analogous to the early collection of amounts due from customers.

Restructuring following a business combination

When a restructuring provision is recognised as one of the liabilities acquired in a business combination (see 2.6), there is some uncertainty regarding the classification of subsequent cash outflows in respect of the restructuring. There is an argument to include them in investing activities because they are directly related to the acquisition of the subsidiary.

However, in our view, the cash flows should not be classified as part of investing activities since they do not represent *the* acquisition itself, as required by the definition (see 2.3.2). Rather, they are cash flows associated with the acquisition. Therefore, we believe that each cash flow should be classified based on the nature of the payment (e.g., operating activities for employee termination benefits).

2.3.5 Foreign exchange differences

IAS 7.25-28 Cash flows arising from an entity's foreign currency transactions should be translated into the functional (measurement) currency (see 2.7) at the exchange rate at the date of the cash flow (when exchange rates have been relatively stable a weighted average can be used). Cash flows of foreign subsidiaries also are translated at actual rates (or appropriate averages). The effect of exchange rate changes on the balances of cash and cash equivalents is presented as part of the reconciliation of movements therein.

Cash held in a foreign currency

The following simple example illustrates the calculation of the effect of exchange rate changes on the balances of cash and cash equivalents and its presentation in the cash flow statement.

	Fx	*Rate*	*Functional currency*
Balance of cash held in foreign currency at 1 January 2004	100	1:1	100
Revenue	100	1.5:1	150
Expenses	(50)	1.6:1	(80)
Balance of cash held in foreign currency at 31 December 2004	150		170
Translate at balance sheet date	150	2:1	300
Gain on cash held in foreign currency			130

Balance sheet

	2004		*2003*
Share capital	100		100
Retained earnings	200	(150 - 80 + 130)	-
	300		100
Cash	300		100

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Cash flow statement extract – direct method

	2004
Receipts from customers	
(all receivables collected by the balance sheet date)	150
Payments to suppliers	
(all invoices paid by the balance sheet date)	(80)
Net increase in cash	70
Cash and cash equivalents at 1 January 2004	100
Effect of exchange rate fluctuations on cash held	130
Cash and cash equivalents at 31 December 2004	300

Cash flow statement extract – indirect method

	2004
Net profit	200
Unrealised foreign exchange gain	(130)
Net increase in cash	70
Cash and cash equivalents at 1 January 2004	100
Effect of exchange rate fluctuations on cash held	130
Cash and cash equivalents at 31 December 2004	300

Other foreign exchange differences

Assets and liabilities denominated in a foreign currency generally include an element of unrealised exchange differences at the balance sheet date. In our view, when applying the indirect method, the unrealised exchange difference should be presented as a single non-cash item within operating activities, rather than being left embedded in the asset or liability. The following simple example illustrates this point.

	Fx	Rate	AC[1]
Loan received during 2002 (converted to AC immediately)	250	1.5:1	375
Translate at balance sheet date	250	2:1	500

Balance sheet (in AC)

	2004		2003
Share capital	100		100
Retained earnings	75	(200 - 125)	200
	175		300
Cash	675		300[1]
Loan	(500)		-
	175		300

Cash flow statement extract – indirect method

	2004
Net loss	(125)
Unrealised foreign exchange loss	125
Net cash from operating activities	-
Loan obtained (financing activities)	375
Net cash increase	375
Cash at 1 January 2004	300
Cash at 31 December 2004	675

Notes

1 Cash on balance at the end of 2003 is held in its own functional (measurement) currency (AC).

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Using the direct method, as there are no receipts from customers or payments to suppliers, net cash from operating activities is zero.

2.3.6 Offsetting

IAS 7.22, 23 Generally, all financing and investing cash flows should be reported gross. Receipts and payments may be netted only when the items concerned (e.g., sale and purchase of investments) turn over quickly, the amounts are large and the maturities are short; or when they are on behalf of customers and the cash flows reflect the activities of the customers.

For example, an entity obtains a loan of 2,000 during the reporting period and uses the proceeds to repay another loan of 2,000. The following should be presented as financing activities: proceeds from borrowings 2,000; and separately, repayment of borrowings 2,000.

IAS 7.24 In addition, a financial institution may report on a net basis certain advances, deposits and repayments thereof that form part of its operating activities. However, not all borrowings of a financial institution are part of operating activities; therefore the above example in relation to financing activities applies equally to a financial institution.

In our view, if a group comprises a combination of financial institution and non-financial institution subsidiaries, each subsidiary would follow the relevant criteria for offsetting.

2.3.7 Taxes collected on behalf of third parties

IAS 7 is silent on the classification of cash flows from taxes that are collected on behalf of third parties when the direct method is used to present cash flows from operating activities; examples include VAT (value added tax) and GST (goods and services tax). In our view, taxes collected on behalf of third parties may be either:

- included as separate line items to show the impact on cash flows of such taxes separately; or
- included in receipts from customers and payments to suppliers.

Although our preference is for the first method, in our experience generally these taxes are included in receipts from customers and payments to suppliers as the impact on the cash flow statement is immaterial (see 1.2).

The following simple example illustrates the alternatives:

Services rendered for cash during 2004 (excluding GST)	100
GST paid to revenue authorities	10
GST payable to revenue authorities (GST collected from customers is 20 of which 10 is paid and 10 remains outstanding to tax authorities)	10

Balance sheet

	2004	*2003*
Share capital	100	100
Retained earnings	100	-
	200	100
Cash	210	100
GST payable	(10)	-
	200	100

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Cash flow statement extract – direct method option 1

	2004
Receipts from customers (all receivables collected by the balance sheet date)	100
Indirect taxes collected	20
Indirect taxes paid	(10)
Net cash increase	110
Cash at 1 January 2004	100
Cash at 31 December 2004	210

Cash flow statement extract – direct method option 2

	2004
Receipts from customers (all receivables collected by the balance sheet date)	120
Payments to tax authorities (all invoices paid by the balance sheet date)	(10)
Net cash increase	110
Cash at 1 January 2004	100
Cash at 31 December 2004	210

Cash flow statement extract – indirect method

	2004
Net profit	100
Increase in accounts payable	10
Net cash increase	110
Cash at 1 January 2004	100
Cash at 31 December 2004	210

2.3.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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2.4 Basis of accounting

(IAS 1, IAS 15, IAS 21, IAS 29, SIC–1, SIC–2, SIC–18, IFRS Glossary Terms)

Overview

- **Financial statements are prepared on a modified historical cost basis, with a growing emphasis on fair value.**
- **When an entity's functional (measurement) currency is hyperinflationary its financial statements must be adjusted to state all items in the measuring unit current at the balance sheet date.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements*, IAS 27 *Consolidated and Separate Financial Statements* and IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. The IASB also has withdrawn IAS 15 *Information Reflecting the Effects of Changing Prices* with effect from 1 January 2005. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text.

2.4.1 The modified historical cost convention

Glossary

IFRSs require financial statements to be prepared on a modified historical cost basis, with a growing emphasis on fair value. Fair value is the amount for which an item could be exchanged or settled between knowledgeable willing parties in an arm's length transaction. Issues associated with the determination of fair value are discussed throughout this publication in connection with the relevant asset or liability.

The following are examples of assets and liabilities whose carrying amounts are determined by reference to cost-based measurements subsequent to initial recognition (ignoring adjustments for impairment):

- property, plant and equipment, intangible assets and investment property that are not revalued; and
- loans and receivables originated by the entity, held-to-maturity investments, and financial liabilities other than those measured at fair value (see 3.6).

The carrying amounts of the following assets and liabilities are based on fair value subsequent to initial recognition:

- All derivatives, all financial assets and financial liabilities held for trading or designated as fair value through income and all financial assets that are classified as available-for-sale are carried at fair value (see 3.6).
- Biological assets must be carried at fair value less point-of-sale costs (see 3.8).
- Provisions must be measured at fair value, which is derived by discounting estimated future cash flows (see 3.11).
- Whole classes of property, plant and equipment may be revalued to fair value subject to certain conditions (see 3.2).
- Certain intangible assets may be revalued to fair value (see 3.3).
- Investment property may be carried at fair value (see 3.4).

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In addition, the following value-based measurements are an integral part of financial reporting under IFRSs:

- Recoverable amount, which is used in impairment testing for many assets (see 3.9), is the higher of the asset's value in use (estimated net future cash flows) and its net selling price (fair value less costs of disposal).
- Net realisable value (estimated selling price less costs of completion and disposal) is used as a ceiling test to avoid over-valuing inventory (see 3.7).
- Discounting is inherent in many IFRSs although the discount rate used varies. For example, defined benefit plans for employees are discounted using a corporate or government bond rate (see 4.4), whereas deferred payment relating to the sale of goods may be discounted using either a market interest rate or a rate of interest that discounts the nominal amount of the instrument to the current cash sales price (see 4.2).

2.4.2 Hyperinflation

IAS 29.8, 21.43

When an entity's functional (measurement) currency (see 2.7) is hyperinflationary its financial statements must be adjusted to state all items in the measuring unit current at the balance sheet date (i.e., it must adopt the current purchasing power concept). Moreover, when an entity has foreign operations (e.g., a subsidiary, associate, or joint venture) the activities of which are not an integral part of the reporting entity and whose functional (measurement) currency is hyperinflationary, the investee's financial statements must be adjusted before being translated and included in the financial statements (see 2.7).

Indicators of hyperinflation

IAS 29.3

Under IAS 29 it is a matter of judgement as to when restatement for hyperinflation becomes necessary. The standard states that hyperinflation is indicated by the characteristics of an economy, which include but are not limited to the following:

- The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency; amounts of local currency held are invested immediately to maintain purchasing power.
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency; prices may be quoted in the stable currency.
- Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short.
- Interest rates, wages and prices are linked to a price index.
- The cumulative inflation rate over three years is approaching, or exceeds, 100 per cent.

It is clear from the wording of the standard that while the 100 per cent numerical indicator is a key factor in identifying hyperinflation, it is not the only factor and should not be considered in isolation. Applying all of these factors could result in a country being considered hyperinflationary when its three-year cumulative inflation rate is, for example, only 80 per cent.

IAS 29.4

While judgement is involved in determining the onset of hyperinflation in a particular case, IAS 29 states a preference for all affected entities to apply the standard from the same date.

IAS 29 is not elective. For example, the standard cannot be adopted when an entity believes that the cumulative effects of inflation are significant and therefore, restatement in accordance with IAS 29 would be helpful, but is not required. In such cases the entity should consider presenting current cost information in accordance with IAS 15# (see below).

Forthcoming requirements

IAS 15

The IASB has withdrawn IAS 15 with effect from 1 January 2005. However, this would not preclude an entity from presenting supplementary current cost information (see 5.8).

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Measuring the inflation rate

The appropriate price index

For most countries there are two main indices that might be used in measuring the general inflation rate: a consumer price index (CPI) and a producer or wholesale price index (PPI or WPI). The CPI measures the change in the cost of a fixed basket of products and services consumed by a "typical household", generally including housing, electricity, food and transportation. The PPI or WPI measures wholesale price levels.

IAS 29.37 IAS 29 requires the use of a general price index that reflects changes in *general* purchasing power. In addition, two of the indicators of hyperinflation refer to the *general* population rather than a specific sector. For these reasons, in our view the CPI is the most appropriate index to use in measuring the inflation rate since it is a broad-based measurement across all consumers in an economy.

The cumulative inflation rate

IAS 29.3 IAS 29 refers to a cumulative inflation rate, but is silent as to whether the calculation should be done on a simple or compounded basis. In our view, a compounded inflation rate should be calculated because the simple rate aggregates three discrete results, without viewing the three-year period itself on a cumulative basis.

For example, the inflation rate in three consecutive years is 20 per cent, 30 per cent and 40 per cent respectively. The cumulative rate calculated on a simple basis is 90 per cent (20 + 30 + 40). However, on a compounded basis the rate is 118 per cent, which is calculated as follows:

- At the start of year one assume the index to be 100
- At the end of year one the index is 120 (100 x 1.2)
- At the end of year two the index is 156 (120 x 1.3)
- At the end of year three the index is 218 (156 x 1.4), which gives a cumulative rate of 118 per cent.

No index available

IAS 29.17 In cases when there is no index available, the standard requires an index to be estimated; the example it provides is using an estimate based on exchange rate movements between the national currency and a relatively stable foreign currency. Although the standard uses this example in the context of the restatement of property, plant and equipment, in our view this method could be used for the restatement of the entire financial statements in cases when no index is available. The same issue will arise when the official indices are considered unreliable, but this problem should be rare.

Mechanics

IAS 29.9 In adjusting for hyperinflation a general price index is applied to all non-monetary items in the financial statements (including equity) and the resulting gain or loss, which is the gain or loss on the entity's net monetary position, is recognised in the income statement.

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The following simple example illustrates the process of restatement.

Index at the end of 2002	100
Index at the end of 2003	150
Index at the end of October 2004	180
Index at the end of 2004	200
Average index during 2004	175

Balance sheets before IAS 29 restatement in 2004

	2004 Historical cost	*2003 Historical cost*
Share capital (contributed at the end of 2002)	100	100
Retained earnings	1,000	800
	1,100	900
Land (acquired at the end of 2003)	600	600
Available-for-sale investments	200	150
Inventories (acquired at the end of October 2004)	100	-
Trade receivables	500	200
Cash	100	350
Loan payable	(400)	(400)
	1,100	900

Income statement before IAS 29 restatement

	2004
Revenue	1,200
Expenses	(1,000)
	200

IAS 29.12 Items in the balance sheet that are either money held or items to be received or paid in money (monetary items) are not restated because the carrying amount represents their value in terms of current purchasing power.

IAS 29.14, 15 All other items in the balance sheet are non-monetary items; they include the components of equity (other than retained earnings) as well as items such as prepaid expenses and income received in advance. In general non-monetary items are restated from the date of acquisition or contribution. However, if an asset or liability has been revalued it is restated only from the date of the valuation; if the item is stated at fair value at the balance sheet date, no restatement is necessary.

IAS 29.24 Restated retained earnings are derived after all other amounts in the restated balance sheet and net income are calculated. Restated retained earnings must be split into net income, gain or loss on net monetary position and other retained earnings. The schedule below illustrates these principles using the example above.

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Balance sheet

	2004 Historical	*Restatement*	*2004 Restated*
Share capital	100	100	200[1]
Retained earnings	1,000	111[2]	1,111
Total equity	1,100	211	1,311
Land	600	200	800[3]
Available-for-sale investment	200		200
Inventories	100	11	111[4]
Trade receivable	500		500
Cash	100		100
Loan payable	(400)		(400)
Net assets	1,100	211	1,311

Notes
1 Share capital contributed in 2002, calculated using 2002 index as 200/100 x 100
2 Balancing figure
3 Land purchased in 2003, calculated using 2003 index as 200/150 x 100
4 Inventory purchased in October 2004, calculated using October 2004 index as 200/180 x 100

IAS 29.8, 34 In applying IAS 29, comparative information is restated so that it is expressed in the measuring unit current at the balance sheet date. This is simply a multiplication exercise – the gain or loss on the net monetary position recognised in the comparative period is not recalculated. In this example all items in the 2003 balance sheet are divided by the index at the end of 2003 (150) and multiplied by the index at the end of 2004 (200).

Balance sheet

	2003 Historical cost comparative	*2003 Restated comparative*
Share capital (contributed at the end of 2002)	100	133
Retained earnings	800	1,067
	900	1,200
Land (acquired at the end of 2003)	600	800
Available-for-sale investments	150	200
Inventories (acquired at the end of October 2004)	-	-
Trade receivables	200	267
Cash	350	467
Loan payable	(400)	(533)
	900	1,200

IAS 29.26 Revenues and expenses recorded in the income statement are updated to reflect changes in the price index from the date that they are recorded initially in the financial statements. In this example an average index is applied. However, averages (i.e., annual, monthly etc.) can be applied only when the overall result is not materially different from the result that would be obtained by indexing individual items of revenue and expense.

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Income statement

	2004 Historical	Details of the Restatement	2004 Restated
Revenue	1,200	171	1,371[1]
Expenses	(1,000)	(143)	(1,143)[2]
Net income	200	28	228
Gain or loss on net monetary position	-	83	83
Total net income	200	111	311

Notes
1 Revenue calculated using average index for 2004 as 200/175 x 1,200
2 Expenses calculated using average index for 2004 as 200/175 x 1,000

IAS 29.9 Because the restatement of the financial statements involves only non-monetary items, it is not intuitive that the resulting gain or loss recognised in the income statement actually relates to the monetary position. The following example illustrates how this works.

An entity is formed on 1 January 2004 and the shareholders contribute cash of 1,000. There are no transactions during 2004. At the end of the year the entity has share capital of 1,000, which is represented by cash. The index at 1 January is 100, and 150 at 31 December. At the end of 2004 share capital is restated to 1,500 (1,000/100 x 150); the cash, being monetary, is not restated and a loss of 500 results. Superficially the 500 is a balancing number in the balance sheet and results from the restatement of the non-monetary item (the share capital). However, actually it relates to the monetary position because the entity would need 1,500 of cash at 31 December in order to be in the same position as having 1,000 of cash at the start of the year, and a loss of 500 actually has occurred.

The loss on the net monetary position recognised in the 2004 financial statements in the above example is determined as follows:

- For all items in the 2004 balance sheet that were restated, compare the restated carrying amount to the carrying amount.
- For transactions that occurred during 2004, compare the restated carrying amount or value to the amount at which the transaction originally was recorded.

Restated balance sheet

	2004	2004 Restated	Difference
Share capital	100	200	(100)
Land	600	800	200

Transactions during 2004

	Original value	2004 Restated	Difference
Inventories	100	111	11
Revenues	1,200	1,371	(171)
Expenses	1,000	1,143	143
Net gain on the monetary position			83

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Translation of comparative amounts in a presentation currency different from functional currency#

Forthcoming requirements

IAS 29.8 When comparative amounts are presented in a presentation currency different from the entity's functional currency, the translation should be in accordance with IAS 21 (see 2.7).

Supplementary historical cost information

When restated financial statements are presented in accordance with IAS 29, in our view it is not appropriate to present additional supplementary financial information prepared on a historical cost basis.

The premise for IAS 29 is that since money rapidly loses its purchasing power in a hyperinflationary economy, reporting an entity's financial position and operating results in the currency of a hyperinflationary economy without restatement would be meaningless to users; comparative figures also would have little or no value. Therefore, the presentation of historical cost information in these cases would be misleading to users of the financial statements.

2.4.3 Changing prices

IAS 15.25 Entities whose functional (measurement) currency is not hyperinflationary are encouraged, but not required, to disclose certain information about the effects of changing prices on a current cost basis#. When an entity elects to provide current cost information, it may do so either by adjusting its primary financial statements or by providing information that is supplementary to its primary financial statements. However, the presentation of current cost information is not common.

Forthcoming requirements

IAS 15 The IASB has withdrawn IAS 15 with effect from 1 January 2005. Therefore, the option to adjust the primary financial statements to a current cost basis is no longer available. Current cost information may be presented as supplementary information (see 5.8).

2.4.4 Accounting policies

Consistency

IAS 8.13 The accounting policies adopted by an entity should be applied consistently to all similar items or, if permitted by an IFRSs, to all similar items within a category. For example, if an entity chooses to account for jointly controlled entities using the equity method (see 3.5) then it must use that method consistently for all jointly controlled entities; it cannot equity account for some and proportionately consolidate others.

IAS 40.33, 53 An exception occurs when a standard allows the application of different methods to different categories of item. For example, if an entity chooses to measure its investment property at fair value, it nonetheless may measure individual properties at cost to the extent that they meet the relevant exemption criteria specified in IAS 40 *Investment Property* (see 3.4).

IAS 2.25, 26 As another example, the cost of categories of inventory that have a similar nature and value should be determined using the same cost formula. While it is clear that a difference in geographical location does not mean that items of inventory are dissimilar, a different end-product might be sufficient. For example, an oil company could not use a weighted average costing formula (see 3.7) for crude oil supplies in the United States but not at other non-United States locations. However, a manufacturer may have computer chips that are used in industrial machinery, and computer chips that are used in domestic appliances; in our view, the cost of the computer chips for each end-product could be measured differently. In our view, a difference in customer demographic (e.g., end-user versus retailer), is not sufficient to justify a difference in costing formula.

IAS 27.21 (2000) IAS 27 requires that accounting policies within a group should be consistent unless impracticable (see 2.5)#. No guidance is given on what might be considered impracticable. However, in our view, this would occur only in the rare case either when restatement is not possible or when the difference would not have a material effect on the consolidated financial statements.

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Forthcoming requirements

IAS 27.28 The revised IAS 27 eliminates the current impracticability exception to the requirement to use uniform accounting policies. Therefore, accounting policies with a group will have to be consistent in all cases.

Judgement#

Forthcoming requirements

IAS 1.113 The revised standard adds new disclosure requirements of judgements (other than estimates, see below) made by management in applying accounting policies. Disclosure is required of the judgements that have the most significant effect on the measurement of items recognised in the financial statements (e.g., whether risks and rewards have been transferred or whether a special purpose entity is controlled).

Estimation#

Forthcoming requirements

IAS 1.116 The revised standard adds new disclosure requirements of the key assumptions about the future, and other sources of estimation uncertainty. Disclosure is required of estimates that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. The assumptions on which these estimates are based may be management's most difficult, subjective or complex and disclosure should be considered carefully.

2.4.5 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed below.

Financial reporting standards for small and medium-sized entities

The Board has begun a project to develop accounting standards suitable for small and medium-sized entities (SMEs) with the purpose of reducing the financial reporting burden on SMEs that want to use global standards. In June 2004, the IASB issued a Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* setting out the approach it intends to follow in developing IASB accounting standards for small or medium-sized entities (SMEs). The project is ongoing.

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2.5 Consolidation

(IAS 27, SIC–12, IFRS 3)

Overview

Recent revisions to IFRSs introduce significant amendments to the accounting discussed below (see *Forthcoming requirements*).

- **Consolidation is based on control, which is the *power* to govern the financial and operating policies of an entity so as to *obtain benefits* from its activities.**
- **Potential voting rights that presently are exercisable or convertible are taken into account in assessing control.**
- **Special purpose entities (SPEs) are consolidated in many cases when benefits flow back to the sponsor.**
- **A subsidiary is not consolidated if it operates under severe long-term restrictions that significantly impair its ability to transfer funds to the parent, or if it is acquired and held exclusively for disposal in the near future#.**
- **Subsidiaries excluded from consolidation are treated as financial assets#.**
- **Venture capitalists must consolidate all subsidiaries.**
- **Uniform accounting policies must be used throughout the group unless impracticable#.**
- **The difference between the reporting dates of a parent and a subsidiary cannot be more than three months#.**
- **Minority interests are computed based on either the carrying amounts in the subsidiary or the carrying amounts on consolidation#.**
- **Losses in a subsidiary may create a debit balance on minority interests only if the minority has an obligation to fund the losses.**
- **Minority interests are classified separately from parent shareholders' equity and liabilities in the balance sheet#.**
- **Intra-group transactions are eliminated in full.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 27 *Consolidated and Separate Financial Statements* which incorporated SIC–33 *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests* within the revised standard. In March 2004, the IASB issued IFRS 3 *Business Combinations* and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular the revised standards:

- require that all subsidiaries be consolidated, including those subject to severe long-term restrictions which limit their ability to transfer funds to the parent and those acquired and held exclusively with a view to resale;

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- remove the impracticability exemption thus requiring the use of uniform accounting policies;
- require that minority interest be classified within equity but separate from parent shareholders' equity in the balance sheet;
- require that minority interests be computed based on the carrying amounts on consolidation; and
- clarify that the reporting dates of the parent and a subsidiary may only be different if it is impracticable to prepare additional financial statements of the subsidiary for consolidation purposes. In any case, the difference cannot be greater than three months.

2.5.1 Entities included in the consolidated financial statements

IAS 27.4, 12, 13 Consolidated financial statements should include all subsidiaries of the parent except in limited circumstances (see below)#.

The definition of a subsidiary focuses on the concept of control and has two parts, both of which must be met in order to conclude that one entity controls another:

- the power to govern the financial and operating policies of an entity…
- … so as to obtain benefits from its activities.

SIC 12.9 There is no requirement in IAS 27 for the parent to have a shareholding in a subsidiary, and this is not a necessary pre-condition for control.

IAS 27.13 IAS 27 presumes that control exists in *any* of the following circumstances:

- the investor has power over more than one half of the investee's voting power through ownership or an agreement with other investors;
- the investor has the power to govern the investee's financial and operating policies by virtue of a statute or agreement;
- the investor has the power to appoint or remove the majority of the investee's governing body members; or
- the investor has the power to cast the majority of votes at meetings of the investee's governing body.

IAS 27.13 The presumption of control may be rebutted in exceptional circumstances if it can be demonstrated clearly that control does not exist, which will depend on the facts and circumstances of each case.

Forthcoming requirements

IAS 27.BC15, IFRS 5.6, 11 Under the revised standard, an entity is required to consolidate all subsidiaries, including a subsidiary that operates under severe long-term restrictions which limit its ability to transfer funds to the parent or is acquired and held exclusively with a view to its subsequent disposal (see below). An entity considers severe long-term restrictions when assessing its ability to control an entity, but such restrictions do not in themselves preclude control.

2.5.2 The power to govern the financial and operating policies of an entity

Power versus de facto control

IAS 27.4, 13 Consolidation is based on the *power* to control (i.e., the ability of one entity to control another), regardless of whether that power is exercised in practice. This disregard for exercise of control is consistent with the examples of circumstances giving rise to control that are listed in IAS 27 (see above), which all have a legal or contractual basis. Therefore, in assessing control it is important to consider whether the ability to control has a legal or contractual basis rather than whether that control actually is exercised.

For example, A owns 60 per cent of the voting power in B, but never attends or votes at shareholder meetings and takes no other interest in running B's operations. In our view, A has the *power* to control B because it can step in and exercise its rights at any time, for example, if it is not satisfied with how B's operations are being run. Accordingly, A should consolidate B.

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However, the position is less clear when an entity appears to have control over another entity despite none of the indicators in IAS 27 being present. For example, C owns 40 per cent of the voting power in D; the rest of the voting power is held widely and in practice the views of C go unopposed at shareholder meetings. This has led to the majority of D's governing body being appointed from nominations made by C. In this case C has *de facto* control over D since it controls the operations in practice. However, it does not have the *power* to control the investee since the other shareholders could unite to oppose C. In our view, since consolidation under IFRSs is based on the power to control and does not make any reference to *de facto* control or the existence of a dominant influence, C should not consolidate D in this case. In cases such as this it is important to consider all the facts and circumstances carefully before reaching a conclusion.

Governance structures#

In determining whether an entity controls another, a clear understanding of the investee's governance structure is necessary. In many countries the governing body is the board of directors; however, in other countries there are layers of governance. Although the law may provide for different bodies to have certain rights and obligations, in assessing control any shareholders' agreements that amend these "typical" rights and obligations should be considered.

For example, there might be a supervisory board and an executive board. The executive board often determines the detailed financial and operating policies, whereas the supervisory board has a more detached role in overseeing the actions of management on behalf of shareholders and employees. Therefore, generally the executive board is the governing body for the purpose of identifying control under IAS 27.

However, before reaching any conclusion it would be necessary to consider the respective roles of the supervisory and executive boards in a particular case. In some cases the usual role of the supervisory board is altered to give it much more authority over the entity's financial and operating policies; this is becoming increasingly common recently as the focus on corporate governance increases. For example, the supervisory board might approve the annual budgets and operational planning; or it might have the power to appoint or dismiss members of the executive board. Depending on the circumstances it might be appropriate to conclude that the supervisory board is the key governing body for the purpose of determining control under IFRSs.

Another potential example is the role of a nominations committee, which is relevant in considering who has the power to appoint or remove the majority of the governing body members. For example, a single shareholder might have the *power* to nominate governing body members, but the operation of a nominating committee might require those nominees to be approved unanimously by a number of parties, including certain shareholders and employee representatives. Whether the role of a nominating committee is relevant in a particular case will depend on the circumstances. In this example, if the nominating shareholder also has the power to alter the operations of the nominating committee so that it can appoint or remove governing body members unopposed, then, notwithstanding the participation of the committee, that shareholder still has the power to appoint or remove the majority of the governing body members.

Forthcoming requirements

IAS 27.13 (c), (d) The revised standard clarifies that control is presumed to exist when the investor has the power to appoint or remove the majority of the investee's board of directors or governing body members and control of the entity is exercised through that board or body. Similarly, control is presumed to exist where the investor has the power to cast the majority of votes at a meeting of the investee's board of directors or governing body, and control of the entity is exercised through that board or body.

Shareholders' agreements

IAS 27.13 Shareholders' agreements may be an important part of assessing control. For example, E owns 60 per cent of the voting power in G, and F owns the other 40 per cent. E therefore appears to have

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the power to control G. However, E has entered into an agreement with F such that E defers to the wishes of F with respect to voting; E has done this because it has no expertise in the area of G's operations. Therefore, in accordance with this agreement F has the power to control G.

However, before concluding automatically that a shareholders' agreement confers power on a particular party, the break-up provisions in the agreement, as well as its duration, should be considered. Continuing the above example, suppose that E can discontinue the agreement at any time without penalty. In that case our view is that E has the power to control G since it can step in and exercise its rights at any time.

If a shareholders' agreement has a fixed duration, depending on the facts and circumstances, it might be appropriate to conclude that the agreement is for too short a period to have any real impact on the power of control.

While a shareholders' agreement generally will be in writing, this is not a requirement of the standard. In our view, an oral shareholders' agreement may be as important as a written agreement in assessing control.

Management versus governance

IAS 31.12

In assessing the power to govern it is necessary to distinguish between the management of the operations and their control. A manager does not have control of an entity simply by virtue of running the daily operations, when it does so only within the financial and operating policy framework established by another entity. Although IAS 27 is silent on this issue, it is clarified in IAS 31 when accounting for joint ventures.

For example, H owns 70 per cent of the voting power in K, and J owns the other 30 per cent. In addition, J runs the daily operations of K since it has expertise in that area. However, H actually has the power to govern the operations of K since it has the majority of voting power and therefore, has the power to remove J as manager.

Economic power

SIC 12.A

A party may be able to restrict the freedom of another entity by virtue of their trading or economic relationship. Examples of parties that may have such power include financiers, trade unions, public utilities, government departments or agencies, and major customers and suppliers. Such relationships do not give rise to the power to control in the sense of IAS 27 because the relationship is not one of investor-investee. This is clarified in SIC–12 which notes that economic dependence (such as relations of a supplier to a significant customer) does not, by itself, lead to control.

The rights of minorities

In many cases minorities have certain rights even if another party owns the majority of the voting power in an entity; sometimes these rights are derived from law, and other times from the entity's constitution.

IFRSs do not address the issue of minority rights, but in our view it is necessary to consider the nature and extent of the rights of minorities in determining control. In this case, it is useful to refer to the guidance in US GAAP (EITF 96-16) and the distinction between participative rights that allow minorities to block significant decisions that would be expected to be made in the ordinary course of business, and rights that are only protective in nature. For example, approval of the minority may be necessary for:

- amendments to the entity's constitution;
- the pricing of related party transactions;
- the liquidation of the entity or the commencement of bankruptcy proceedings; and
- share issues or repurchases.

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In our view, these minority rights are protective and would not in isolation overcome a presumption of control by the majority holder of voting power.

The EITF considered a number of participating rights and raised questions about the presumption of control. For example, approval of the minority may be necessary for:

- appointing and removing governing body members, including the setting of their remuneration; or
- making operating and capital decisions, including approving budgets, in the ordinary course of operations.

In our view, granting such right to minorities may overcome the presumption of control under IFRSs when considered together with all other facts and circumstances.

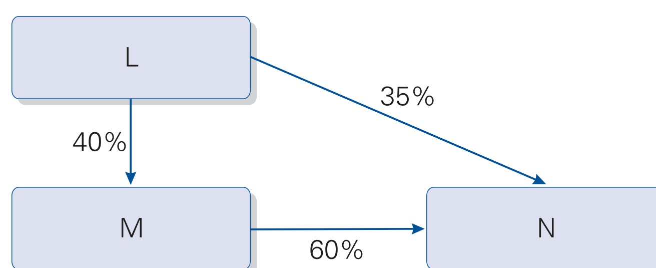
In considering the significance of rights given to minorities, it also is important to consider what happens in the event of deadlock. For example, if the minority shareholders have the power to veto the investee's annual operating budget, this may indicate that the majority shareholder does not have the power to govern the operations of the investee. However, if the constitution provides that the minority shareholders have the right to object to the annual budget, and the majority shareholder is obliged to listen and respond to those concerns, but is not obliged to change the budget or to enter into independent discussions to decide the outcome, then we believe that the minority rights are likely to be more protective than participative and would not, in isolation, overcome the presumption of control by the majority holder of voting power.

Other rights that should be considered include minority approval of major asset acquisitions and disposals, distributions and financing.

Indirect holdings

Indirect holdings may or may not result in an entity having control over another. Although the total ownership interest may exceed 50 per cent, this may not mean that the entity has control.

For example, L owns 35 per cent of the voting power in N, and 40 per cent of the voting power in M. M owns 60 per cent of the voting power in N. Therefore, L has, directly and indirectly, a 59 per cent ownership stake in N. However, L does not control 59 per cent of the vote because it does not have control over the votes exercised by M – it is limited to significant influence (see 3.5). Therefore, in the absence of any contrary indicators, L does not control N.



IAS 27.13 This issue is alluded to in IAS 27 when it refers to voting power held indirectly through *subsidiaries* (i.e., not through associates or lesser investments).

Control versus fellow subsidiaries

In some cases it is not clear whether one entity is controlled by another entity, or whether they are both under the control of a third entity. This issue sometimes arises in a closely held group of entities.

For example, individual P owns 100 per cent of the voting power in entity Q, which owns 10 per cent of the voting power in R. Individual P owns 55 per cent of the voting power in R indirectly through a number of other subsidiaries. The remaining 35 per cent of R's voting power is widely held. The

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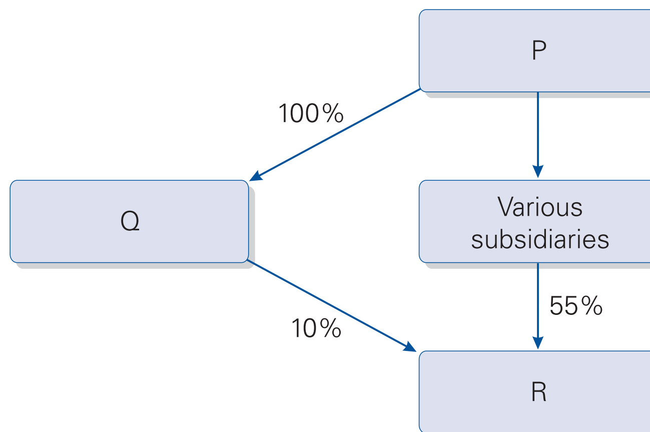
governing bodies of Q and R are identical, and include P. Initially it may appear that Q controls the operations of R since the governing body members are identical. However, in the absence of any contrary indicators, it is individual P who controls both Q and R in this case. Therefore, it would not be appropriate for Q to consolidate R; rather, they are sister entities under the common control of P.



2.5.3 So as to obtain benefits from its activities

SIC 12.9, 10 Although IFRSs are silent on the matter, in our view, the benefits referred to in the definition of control are the benefits derived from having the power to govern the financial and operating policies of an entity. This is supported by the consensus reached in SIC–12 in respect of SPEs (see 2.5.6). Benefits received from ordinary business transactions are not benefits that lead to control to the extent that the terms of the transactions are established on an arm's length basis. For example, if a shareholder sells inventory to the investee, the sales price of the goods is a normal trading benefit as long as the investee does not pay more or less than any of the shareholder's other customers under similar conditions.

IAS 27.4 Control does not require the parent to receive a *majority* of the benefits from the subsidiary. For example, an entity issues A and B shares. They carry equal voting rights, but class A shares have far greater rights to dividends in the event of a distribution. S owns 60 per cent of the voting power in the entity, but receives only 10 per cent of the dividends. In the absence of any other contrary indicators, S controls the entity despite its share of benefits being disproportionately low compared with its power.

While the benefits of ownership normally are realised in the form of dividends, this is not necessary to establish control over an entity. This is consistent with the absence of a requirement for the parent to hold shares in a subsidiary (see 2.5.1). For example, T appoints the majority of W's governing body members through an agreement entered into with W's shareholders. T receives no dividends from W, but it receives a management fee based on W's profits that far exceeds the fee that might be expected in the market. In our view, such a benefit should be considered a benefit of control under IFRSs.

In summary, the key issue is assessing whether benefits may be obtained. No single aspect of benefits – magnitude, form or mechanism for receipt – is determinative on its own.

2.5.4 Potential voting rights

IAS 27.14 In assessing control, the impact of potential voting rights that are exercisable presently (i.e., currently) should be considered. Potential voting rights held both by the entity and by other parties are taken into account. Such potential voting rights may take many forms, including options, warrants, convertible shares, or contractual arrangements to acquire shares.

For example, X owns 40 per cent of the voting power in A, Y owns 25 per cent and Z owns the other 35 per cent. Also, X holds a call option to acquire from Y an additional 20 per cent of the

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voting power in A; the call option, whose strike price is fair value, can be exercised at any time. Accordingly, it is X that has the power to control A. Therefore, X consolidates A, but reflects a 60 per cent minority interest.

IAS 27.15 Management's intentions with respect to the exercise of potential voting rights are ignored in assessing control because these intentions do not affect the existence of the *ability* to exercise power. Continuing the above example, even if X had no intention of exercising the call option it still would be deemed to have the power to control A.

IAS 27.15 The exercise price of potential voting rights, and the financial capability of the holder to exercise them, also are ignored. However, the capability to exercise power does not exist when potential voting rights lack economic substance (e.g., when the price deliberately is set so high that the chance of the potential voting rights being exercised is remote).

2.5.5 Rebutting the presumption of control

IAS 27.13 As noted above, it is possible for an entity that has less than a 50 per cent interest in another entity to be considered its parent so long as it controls that other entity. Similarly, ownership of more than a 50 per cent interest may not give rise to control. The determination of where control lies is a question of fact to be determined after considering all relevant facts and circumstances, examples of which are discussed in 2.5.2 to 2.5.4.

IAS 27.13, 14 A related issue is whether an entity could have two parents. For example, D holds 60 per cent of the voting power in F, but E has the right to appoint and remove a majority of F's governing body members. The indicators in IAS 27 might lead to a conclusion that both D and E should consolidate F. However, control is a question of fact and there should be only one parent because no more than one entity can have the current power to control. In this example it would be necessary to consider how the financial and operating policies of F are set, and the rights of the shareholders in general meetings *vis-à-vis* the rights of the governing body members.

2.5.6 Special purpose entities

SIC 12.3, 9 A SPE is an entity created to accomplish a narrow and well-defined objective (e.g., a vehicle into which trade receivables are securitised). The principles discussed above for identifying control apply equally to a SPE. However, SIC–12 sets out additional guidance since many of the traditional indicators of control (e.g., power over more than half of the voting rights as a result of ownership or contractual agreement) are not present in a SPE; for example, the activities of the SPE may be pre-determined so that there is no need for a governing body.

SIC 12.6 SIC–12 does not apply to post-employment benefit plans or equity compensation plans. The treatment of entities that may exist in relation to such plans (e.g., employee benefit trusts) is discussed in 4.4 and may be subject to future developments (see 2.5.16).

SIC 12.10, 12 SIC–12 is based on the substance of a relationship between an entity and a SPE, and considers a number of factors that are discussed below. Each factor should be analysed independently. Also important to bear in mind when analysing a SPE is the requirement to account for the substance and economic reality of a transaction rather than only its legal form (see 1.2).

Business needs

SIC 12.10, 12.A Determining whose business needs the SPE benefits requires an evaluation of the SPE's purpose, its activities and which entity benefits most from them. An example is when the SPE is engaged in an activity that supports one entity's ongoing major or central operations.

For example, G sells its main operating asset to a SPE and then leases it back (see 5.1); a bank provides the SPE's capital. In the absence of any contrary indicators, it appears that the SPE has been set up primarily to support the business needs of G.

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This indicator of control often is difficult to evaluate as there may be more than one party that derives some benefits from the SPE. In that case, an evaluation of the majority of benefits is necessary.

Decision-making powers

SIC 12.10, 12.A

Many SPEs run on auto-pilot because all key decisions have been made as part of the formation of the SPE and delegated to other parties (managers). In such cases, it is necessary to identify the entity that made all the key decisions and delegated their execution as part of the process of identifying the party that obtains the majority of benefits from the SPE's activities.

For example, major decisions that relate to the operations of a SPE that holds securitised receivables include the profile of receivables eligible for securitisation, servicing arrangements, liquidity facility arrangements, the ranking of claims against the SPE's cash flows, and the wind-up of the SPE. If it is determined that the transferor made these key decisions, then it is likely to be deemed to have control over the SPE. Even if the conclusion is that the transferor did not make these key decisions, the other indicators of control in respect of SPEs still may lead to a conclusion that the transferor should consolidate the SPE.

The majority of risks and benefits, and ownership of the residual interests

SIC 12.10, 12.A

An evaluation of the majority of risks and benefits, and the ownership of the residual interests in a SPE, often is the most crucial element of determining whether consolidation of a SPE is necessary. In our view, the analysis of benefits and risks is focused on the residual-type benefits and risks rather than the gross cash flows of all of the assets and liabilities in the SPE. For example, if there are reserves or equity that would be distributed when the SPE is wound up, an entity entitled to the majority of this potential upside may be required to consolidate the SPE.

Although risk is not part of the definition of control in IFRSs, in analysing a SPE often the risks are easier to identify than the benefits. Therefore, the focus often is on analysing the risks on the basis that an entity would not assume risks without obtaining equivalent benefits, which in turn may lead to a presumption of control. In evaluating the majority of risks, if for example there are senior and subordinated cash flows in a SPE, the evaluation should focus on the exposure to subordinated cash flows and any residual equity. An entity with the majority of this exposure may be required to consolidate the SPE.

For example, an entity (transferor) transfers 110 of receivables into a SPE for proceeds of 100, with 10 being overcollateralisation for the transaction. If credit losses are greater than 10, these excess losses are absorbed by the transferee, or rather the equity holders in the SPE; if the excess losses are less than 10, the transferor receives the difference as a refund. Historically credit losses have amounted to four and this trend is expected to continue. The transferor's position could be analysed in one of two ways:

- The transferor does not bear the majority of the risk associated with the SPE since the 10 represents only 10 per cent of the maximum potential losses. Therefore, the transferor should not consolidate the SPE. In our view, this is not the appropriate interpretation of SIC–12.
- The transferor bears the majority of the risk associated with the SPE since the 10 is expected to cover all expected losses. Therefore, the transferor may be required to consolidate the SPE. In our view, this is the appropriate interpretation of SIC–12.

An entity may provide servicing to a SPE. As noted above, in our view, an arm's length and market-based servicing fee for services performed would not be viewed as receiving benefits from the SPE. However, a servicing fee that varies based on the performance (or non-performance) of the SPE's assets, or that entitles the servicer to residual benefits might be akin to the servicer having the ability to obtain benefits from, or being exposed to, the risks of the SPE, in which case consolidation might be required.

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2.5.7 Multi-seller SPEs

Sometimes a SPE obtains assets from multiple, and often unrelated, entities. These SPEs sometimes are referred to as "multi-seller" SPEs, or "commercial paper conduits" if they issue notes backed by short-term financial assets obtained from other entities. Often these SPEs are sponsored by a financial institution that does not transfer any of its own assets into the SPE.

For multi-seller SPEs where the transferor retains some risk with respect to the transferred assets, and those assets are *not* cross-collateralised with other assets in the SPE, in our view each transferor of assets should evaluate the risks and benefits only of those assets that it has transferred to the SPE. This is sometimes referred to as a "ring-fenced" approach as each transfer is evaluated as if it is an individual cell within the SPE.

On the other hand, if all transfers of assets to a multi-seller SPE cross-collateralise each other, then the transferor should evaluate its risks and benefits in relation to all assets held by the entire SPE. In this case it becomes less likely that any one transferor would be viewed as having a majority of the residual risks or benefits of the multi-seller SPE; instead, the SPE may be viewed as having been created for the business needs of the sponsoring financial institution.

2.5.8 Investment funds

Investment funds have many characteristics that are similar to SPEs, and should be evaluated for consolidation by both the investment manager and investors. However, generally it is the role of the investment manager that requires the most careful analysis, in particular:

- the powers of the investment manager, and whether the manager can be removed by the investors; and
- the benefits obtained by the investment manager in return for the services rendered, including whether the investment manager also is an investor.

Although it is necessary to consider all the facts and circumstances of each individual case, consolidation by the investment manager normally is not required when:

- the manager has only a small investment in the fund, if any;
- the risk borne by the manager is commensurate with the size of its investment and the risks borne by other investors;
- the management fees are commensurate with the services performed by the manager, are at market rates, and are not based on the residual interests in the fund; and
- the investors have the right to replace the manager.

If any of the above conditions are not met, a consideration of all the facts and circumstances still may indicate that the investment manager controls and should consolidate the fund.

2.5.9 Structured transactions

There is no formal definition of a structured transaction. However, typically a structured transaction arises when parties undertake a series of actions to achieve a desired outcome. The following are possible examples:

- assets are transferred into a SPE, which may or may not be controlled by the transferor (a securitisation of receivables often takes this form); and
- an entity obtains control of an investee with a view to increasing its shareholding at a later date.

The analysis of a vehicle that arises from a structured transaction takes into account all of the factors described above. However, often such transactions have characteristics that require careful consideration. In addition, it is important to bear in mind the substance of the transaction as a whole

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in cases when the complete transaction comprises a series of smaller transactions that would be accounted for differently if each one was viewed in isolation.

The use of derivatives, including potential voting rights, is much more common in structured transactions. The terms and conditions of the derivatives need to be considered to determine the impact that the derivatives may have on the rights of the parties involved. In derecognition transactions, an analysis of the derivatives involved also may result in the conclusion that the underlying asset should not be derecognised in the first place (see 3.6).

The rights of minorities often are a key feature, especially in transactions when the parent may wish to increase its shareholding at a later date. For example, an entity acquires a 60 per cent interest in an entity and has a call option to acquire the remaining 40 per cent at a specified date in the future; the minority has a put option to sell its 40 per cent interest to the entity at a specified date in the future. The terms of the options are such that the entity will acquire the remaining 40 per cent if both parties act in a rational economic manner, and the amount paid to the minority in substance provides it with a lender's return on its investment in the entity. The key issue is whether the parent has a 60 per cent subsidiary with a 40 per cent minority, or a 100 per cent subsidiary with debt funding. In our view, given the absence of any contrary indicators in the case, the minority is a borrowing that should be recognised as a liability.

2.5.10 Exclusions from consolidation#

IAS 27.13, 14 (2000)

A subsidiary shall be excluded from consolidation in only two cases:

- if there are severe long-term restrictions; or
- if the subsidiary was acquired solely with a view to its disposal in the short-term.

Subsidiaries cannot be excluded from consolidation on the basis that their activities are dissimilar from those of the parent, because relevant information may be provided by consolidation of such subsidiaries and the provision of additional information concerning the impact of those activities.

IAS 27.13 (2000)

Subsidiaries exempted from consolidation are accounted for as financial assets under IAS 39. The classification of such investments is discussed in 3.6.

Forthcoming requirements

IAS 27.BC15, IFRS 5.6, 11

The revised standards remove these two exclusions and require that an entity consolidate all subsidiaries.

Severe long-term restrictions#

IAS 27.13 (2000)

The first consolidation exemption is when the subsidiary operates under severe long-term restrictions that impair significantly its ability to transfer funds to the parent. In our view, the transfer of funds should be interpreted as funds related to the benefits of ownership (see 2.5.3).

For example, foreign exchange restrictions imposed upon a subsidiary mean that it is unable to pay dividends to its parent. However, it receives regular shipments of inventory from its parent and is able to pay for the inventory, but at market rates. In this case it appears that severe long-term restrictions exist because the subsidiary is restricted from transferring the benefits of ownership to the parent even though it can settle operating liabilities.

In another example, a subsidiary is unable to pay dividends to its parent, but is able to repatriate similar funds through a management fee. In this case it appears that the subsidiary is not restricted from transferring the benefits of ownership to the parent.

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This exemption from consolidation applies only to restrictions that are long-term. For example, a government imposes severe restrictions on the repatriation of funds. However, immediately following the restrictions there might be no indication that they will remain in place in the long-term. In that case, in our view the subsidiary should continue to be consolidated. Our view is that the situation should be monitored and consolidation of the subsidiary should cease to be consolidated only once it appears that the restrictions will be in place in the long-term.

Forthcoming requirements

IAS 27.BC 15

Under the revised standard, an entity is required to consolidate a subsidiary even though that subsidiary operates under severe long-term restrictions that impair significantly its ability to transfer funds to the parent. An entity considers such restrictions when assessing its ability to control an entity but they do not in themselves preclude control.

Disposal in the near future#

IAS 27.13 (2000)

The second exclusion is where control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

IAS 27 does not define "near future". In our view, in the absence of compelling reasons to permit a longer period, it should be interpreted as meaning that disposal will take place by the end of the first annual accounting period commencing after the acquisition. This view reflects the period allowed under IAS 22 for the adjustment of goodwill as a result of changes made to the carrying amounts of identifiable assets and liabilities acquired in a business combination.

IAS 22.8 (1998)

One issue in practice is whether the subsidiary to be disposed of must comprise a legally separate entity, or whether it could be a component of a larger entity, such as a division or branch. In our view, the entity held for disposal need not be legally separate but must be an operation that, if acquired separately, would be considered a business combination in accordance with IFRSs (see 2.6).

Forthcoming requirements

IFRS 5.6, 11

In March 2004, the IASB issued new guidance on accounting for assets held for sale. Under this new standard, an entity is required to consolidate a subsidiary even if it is acquired exclusively with a view to its subsequent disposal. However, the disposal group (comprising the assets that are to be disposed of and directly related liabilities) is classified in the consolidated financial statements as held for sale at the acquisition date if certain criteria are met at the date of acquisition or within a short period afterwards (see 5.4A).

Immaterial subsidiaries#

Although IFRSs do not address explicitly the treatment of immaterial subsidiaries, in our view subsidiaries do not need to be consolidated if, alone and in aggregate, they are *immaterial* (see 1.2) to the financial position, performance and cash flows of the group – whether consolidated or accounted for at fair value.

Forthcoming requirements

IAS 1.11, 29-31

The revised standard clarifies that materiality depends on both the size and nature of the omission or misstatement (or a combination of the two) judged in the surrounding circumstances. In considering materiality, the nature of a subsidiary may be important, for example, if it is a SPE. In our view, the non-consolidation of a subsidiary should be reconsidered in preparing financial statements at each reporting date.

2.5.11 Venture capital entities

IAS 27.19, 37

Venture capital entities and unit trusts are not exempt from the requirements of IAS 27 and their subsidiaries must be consolidated. This is notwithstanding the view that the aggregation of modified historical cost balance sheets and income statements may present less relevant information to investors who are concerned primarily with the fair value of each individual investment in a portfolio

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and the net asset value per share. If appropriate, information about the fair value of investments may be disclosed in the notes to the consolidated financial statements, or additional separate financial statements in which investments are recognised at cost or fair value may be prepared.

2.5.12 Subsidiaries' accounting periods and policies

IAS 27.19 (2000) When practicable, a subsidiary's accounting period for the purposes of consolidation should be the same as that of the parent#. When different periods are used the gap must be no more than three months and adjustments should be made for significant transactions in the intervening period.

IAS 27.27 When there is a difference between the balance sheet dates of the parent and a subsidiary, the length of the reporting periods and the gap between them should be consistent from period to period. However, IFRSs are silent on the approach to take when a subsidiary changes its balance sheet date in order to align its reporting period with that of the parent.

For example, the parent has a balance sheet date in December, and its subsidiary's balance sheet date is in October. Each year the consolidated financial statements are prepared using financial information for the subsidiary at 31 October, adjusted for any significant transactions in November and December. In 2004 the subsidiary changes its balance sheet date to December. In our view, the 2004 consolidated financial statements should include the results of the parent for the 12 months to December 2004, and the results of the subsidiary for the 14 months to December 2004, unless the parent already has included the subsidiary's transactions in that time as adjustments made for significant transactions. In our view, this is more appropriate than an alternative approach of adjusting the group's opening retained earnings at 1 January 2004 in respect of the results of the subsidiary for the two months to December 2003 – an approach that would be necessary to limit the consolidated financial statements in the current period to 12 months of the subsidiary's results.

Forthcoming requirements

IAS 27.26, 27 Revised IAS 27 requires that the financial statements of the parent and its subsidiary should be prepared as of the same reporting date. When the reporting dates are different, additional financial statements of the subsidiary are prepared as of the same date as the financial statements of the parent unless it is impracticable to do so. In any case, the difference between the reporting dates of the parent and subsidiary must not be greater than three months and adjustments must be made for the effects of significant transactions and events in that period.

IAS 27.21 (2000) For the purpose of consolidation, the financial information of all subsidiaries should be prepared on the basis of IFRSs. When practicable, uniform accounting policies should be used throughout the group#. If it is not practicable to use uniform accounting policies, this fact should be disclosed together with the proportions of the items in the financial statements to which different accounting policies have been applied.

Forthcoming requirements

IAS 27.28, 29 Revised IAS 27 requires uniform accounting policies to be used for like transactions and events. Therefore, if a subsidiary uses different accounting policies from those applied in the consolidated financial statements, appropriate consolidation adjustments to align accounting policies must be made when preparing those consolidated financial statements, even if these adjustments previously had been considered impracticable.

2.5.13 Minority interests

Initial measurement

IAS 22.32-35 (1998) The benchmark treatment for minority interests is to measure them based on the carrying amounts of the assets and liabilities as reported by the subsidiary itself. Under the allowed alternative treatment, minority interests are calculated as the minority share of the identifiable assets and liabilities of the subsidiary measured at fair value (see 2.6)#.

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Forthcoming requirements

IFRS 3.40 In March 2004, new guidance was issued on accounting for business combinations. Under the new standard, minority interests must be measured initially based on the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities at the date of acquisition (see 2.6). The benchmark treatment allowed previously of measuring minority interests based on the book value of the subsidiary no longer is available under revised IAS 27.

Percentage attributable to minority interests

In some cases the economic interests of investors will not equal their shareholding. For example, an entity may control 60 per cent of the voting power, but have only a 55 per cent economic interest in the profits and net assets. In our view, minority interests should be measured based on the 45 per cent economic interest.

Potential voting rights

IAS 27.23 Even though control of an entity takes into account potential voting rights (see 2.5.4), the calculation of minority interests generally is based on current ownership interests.

For example, H owns 40 per cent of the voting power in J and has a call option, exercisable currently, to acquire a further 20 per cent of the voting power from K. Based on the combination of current ownership and potential voting rights, H controls J. In preparing the consolidated financial statements the minority interest in J will be 60 per cent.

SIC 33.5, 33.B (2001) Continuing the above example, an exception to the general principle arises in the case of a structured transaction when H receives currently the benefits associated with the entire 60 per cent shareholding (i.e., its shareholding is not the same as its economic interest). This might be achieved through the pricing of the call option so that effectively K makes a lender's return on its investment in J. In this case, H has an economic interest of 60 per cent and the minority interest is 40 per cent. Additionally, a liability is recognised in respect of the 20 per cent nominally owned by K since K's interest is not that of an equity holding (minority interest) but rather is a financing obligation.

Losses

IAS 27.35 Losses that exceed the minority interest in the equity of a subsidiary may create a debit balance on minority interests only if the minority has a binding obligation to fund the losses and is able to make an additional investment to cover the losses. If this is not the case, the losses are attributable to the parent's interest. If the subsidiary subsequently reports profits, these profits are allocated to the majority interest until the share of losses previously absorbed by the majority has been recovered.

Presentation

IAS 27.26 (2000) Minority interests are classified separately from parent shareholders' equity and liabilities in the balance sheet#. In our experience minority interests generally are presented outside of both total equity and liabilities. However, sometimes they are presented within total shareholders' equity, but separately from parent shareholders' equity.

Forthcoming requirements

IAS 27.33 Under revised IAS 27, minority interest must be presented within equity separately from the parent shareholders' equity. Minority interests in the profit or loss of the group also should be disclosed separately.

2.5.14 Intra-group transactions

IAS 27.24 Intra-group balances and transactions, and resulting profits, are eliminated in full regardless of whether the unearned profit is in the parent or the subsidiary. Intra-group losses are eliminated in full except to the extent that the underlying asset is impaired.

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The following simple example illustrates the elimination in a "downstream" sale of inventory from the parent to an 80 per cent subsidiary (ignore tax considerations which are discussed in 3.12).

	Parent	*Subsidiary*
Cost of inventory	700	1,000
Selling price of inventory	1,000	Not yet sold
Net profit prior to elimination	15,000	8,000
Net assets prior to elimination	125,000	65,000

Elimination entry on consolidation:

	Debit	*Credit*
Revenue	1,000	
Cost of goods sold to the subsidiary		700
Inventory		300

Minority share of profit 1,600 = 8,000 x 20%

The above example shows that the minority interest is calculated without regard to the elimination entry because the unearned profit is in the parent's result. This is notwithstanding the fact that the unearned profit is included in the carrying amount of the inventory in the subsidiary's financial statements.

The following example is the same as above except that the 80 per cent subsidiary makes an "upstream" sale of inventory to the parent.

	Parent	*Subsidiary*
Cost of inventory	1,000	700
Selling price of inventory	Not yet sold	1,000
Net profit prior to elimination	15,000	8,000
Net assets prior to elimination	125,000	65,000

Elimination entry on consolidation:

	Debit	*Credit*
Revenue	1,000	
Cost of goods sold to the parent		700
Inventory		300

Minority share of profit 1,540 = (8,000 - 300) x 20%

This example shows that the minority interest is calculated after eliminating the unearned profit that is included in its results. In addition, the minority share of net assets also is calculated after the elimination even though the inventory that was overstated from the group's perspective is in the parent's balance sheet.

2.5.15 Changes in the status of subsidiaries

Disposal

IAS 27.30-32 A subsidiary is consolidated until the date that control ceases. When an interest in a subsidiary is disposed of, the difference between the proceeds from the disposal and the carrying amount of the parent's interest in the subsidiary's assets and liabilities plus the carrying amount of goodwill related to the subsidiary is recognised in the income statement as a gain or loss on disposal. If only part of the subsidiary is disposed of, depending on the level of influence still held by the investor, the

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remaining interest in the carrying amounts of the subsidiary's assets and liabilities and of goodwill is accounted for either:

- as an associate in accordance with IAS 28 (see 3.5);
- as a joint venture in accordance with IAS 31 (see 3.5); or
- as a financial asset in accordance with IAS 39 (see 3.6).

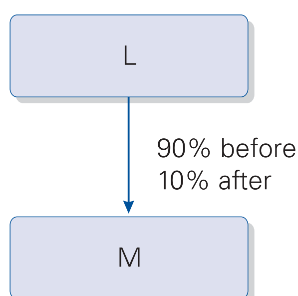
At the date that the investment ceases to be a subsidiary, its carrying amount in the consolidated financial statements is deemed to be the cost thereafter.

The following example illustrates a partial disposal and the calculation of the resulting gain or loss.

L acquired a 90 per cent interest in M for 9,000 on 1 January 2003.

L sells an 80 per cent interest in M for 50,000 on 31 December 2004.

Ignore goodwill amortisation and income taxes.



Financial position of M

	1 January 2003	*31 December 2004*
Share capital	100	100
Retained earnings	5,000	40,000
Net assets	5,100	40,100
Fair value of net assets	5,100	

The goodwill on acquisition is 4,410 (9,000 - 5,100 x 90 per cent) – see 2.6.

The net assets of M at 31 December 2004 also represent the position on consolidation – this is relevant for determining the appropriate journal entries.

Consolidated financial position of L

The consolidated financial position before disposal given in the table is an assumed position.

	Before disposal	*Disposal (see below)*	*After disposal*
Goodwill	4,410	(4,410)	-
Financial asset	-	4,500	4,500
Other net assets	100,000	9,900	109,900
Net assets	104,410	9,990	114,400

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	Before disposal	*Disposal (see below)*	*After disposal*
Current year profit	30,000	14,000	44,000
Retained earnings	69,400	-	69,400
Share capital	1,000	-	1,000
Minority interests	4,010	(4,010)	-
	104,410	9,990	114,400

The disposal comprises the following journal entry (see below for calculations):

	Debit	*Credit*
Other net assets	50,000	
Financial asset	4,500	
Minority interests	4,010	
Goodwill		4,410
Other net assets		40,100
Profit		14,000

Since M is being deconsolidated its net assets, as well as the attributable goodwill and minority interests, are removed from the consolidated balance sheet. They are replaced by a single financial asset that will be accounted for in accordance with IAS 39 (see 3.6).

The credit to net assets of 40,100 was given in the information above, as was the goodwill. Minority interests at the date of disposal are 10 per cent of M's net assets (40,100 x 10 per cent).

The carrying amount of the remaining 10 per cent investment is calculated as follows:

Net assets at date of disposal	40,100
Minority interests	(4,010)
Goodwill	4,410
Carrying amount of subsidiary (90 per cent)	40,500
Therefore, 10 per cent equals	4,500

Therefore, the gain on disposal of 14,000 is the difference between the proceeds of 50,000 and the carrying amount of an 80 per cent interest, 36,000 (40,500 - 4,500). The 4,500 is the initial carrying amount of the investment; however, subsequent to initial recognition the investment will be remeasured to fair value in accordance with IAS 39 (see 3.6).

IAS 27.29 The gain or loss on disposal recorded in the parent's separate financial statements will depend on the parent's accounting policy in respect of investments in subsidiaries (see 3.5). The amount recognised in the separate financial statements will be eliminated on consolidation.

Dilution

A dilution occurs when the parent's interest in a subsidiary decreases without the parent disposing directly of any of its shares in the subsidiary. For example, this will occur when the subsidiary issues shares to parties other than the parent, or the parent does not participate proportionately in a share offer made by the subsidiary. Depending on the extent of the dilution, the parent may cease to have control, and the parent should cease to consolidate the subsidiary; the resulting journal entries would be similar to the above example. Assuming that the parent maintains control of the subsidiary, a gain or loss on dilution will result. Depending on the facts surrounding the dilution, a loss might indicate that the carrying amount of the subsidiary's assets are impaired (see 3.9).

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IFRSs do not discuss the calculation or presentation of dilution gains and losses. In our view, the entity may make an accounting policy election, which should be applied consistently to all such dilutions, either:

- to recognise dilution gains and losses directly in equity – this reflects the view that minority interests are equity interests, notwithstanding the fact that they are presented separately from parent shareholders' equity; or
- to recognise dilution gains and losses in the income statement – this reflects the view that minority interests are not owners in a group and an entity's equity is only that attributable to shareholders of the parent#.

Forthcoming requirements

IAS 27.33 The revised IAS 27 requires the presentation of minority interests within equity. This presentation supports the recognition of increases and decreases in ownership interests in subsidiaries without loss of control as equity transactions in the consolidated financial statements (see 2.6). However, because the issue is not explicitly addressed in IFRSs the above guidance still is applicable.

This area of IFRSs may be subject to future developments (see 2.5.16).

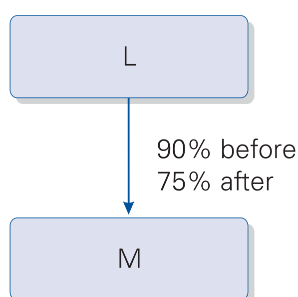
A further issue is whether a portion of the goodwill that arose on acquisition of the subsidiary should be written off as part of the calculation of the gain or loss on dilution. In our view, a portion should be written off because the effect of a dilution is, in substance, the same as a disposal whereby the parent's holding in the subsidiary decreases.

The following example, based on the same basic facts as the previous example, illustrates the calculation of a dilution gain or loss.

L acquired a 90 per cent interest in M, comprising 90 shares, for 9,000 on 1 January 2003.

On 31 December 2004, M issues a further 20 shares to the minority interests and receives proceeds of 18,000.

Ignore goodwill amortisation and income taxes.



Financial position of M

	1 January 2003 (before share issue)	*31 December 2004*
Share capital	100	100
Retained earnings	5,000	40,000
Net assets	5,100	40,100
Fair value of net assets	5,100	

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The goodwill on acquisition is 4,410 (9,000 - 5,100 x 90 per cent) – see 2.6.

The net assets of M at 31 December 2004 also represent the position on consolidation – this is relevant for determining the appropriate journal entries.

Consolidated financial position of L

The consolidated financial position before dilution given in the table is an assumed position.

	Before dilution	*Dilution (see below)*	*After dilution*
Goodwill	4,410	(735)	3,675
Other net assets	100,000	18,000	118,000
Net assets	104,410	17,265	121,675
Current year profit	30,000	6,750	36,750
Retained earnings	69,400	-	69,400
Share capital	1,000	-	1,000
Minority interests	4,010	10,515	14,525
	104,410	17,265	121,675

The dilution comprises the following journal entry (see below for calculations):

	Debit	*Credit*
Other net assets	18,000	
Minority interests		10,515
Goodwill		735
Profit		6,750

The change in minority interests and the gain on dilution are calculated as follows:

	Before dilution	*After dilution*	*Difference*
Net assets of M	40,100	58,100	
Minority percentage	10%	25%	
Minority interests	4,010	14,525	10,515
Parent percentage	90%	75%	
Parent interest	36,090	43,575	7,485

The goodwill of 4,410 relates to a 90 per cent holding. Therefore, goodwill of 3,675 relates to a 75 per cent holding (4,410/90 x 75), which gives a write-off of 735. The gain on dilution is therefore 6,750 (7,485 - 735), which has been recognised in this example in the income statement.

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2.5.16 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Minority interests

As part of its Business Combinations (phase II) Project, the IASB agreed that the losses of a subsidiary should be attributed to both the parent and minority interests based on their ownership interests and any contractual rights and obligations, even if this creates a debit balance of minority interests.

Following from the decision to classify minority interest as part of equity, in December 2002 the Board agreed the following:

- subsequent decreases in ownership that result in a loss of control should result in a gain or loss being recognised in the statement of equity; and
- subsequent decreases in ownership that do not result in the loss of control should be accounted for as equity transactions; therefore no gain or loss would be recognised in the income statement.

Special purpose entities

IFRIC Draft amendment D7 *Scope of SIC–12 Consolidation – Special Purpose Entities*, issued in June 2004, proposes to remove the scope exclusion for equity compensation plans. In addition, D7 proposes to clarify that the exclusion of “post-employment benefit plans” applies to all long-term employment benefit plans with plan assets included in the measurement of a defined benefit liability or a liability for other long-term employee benefits under IAS 19.

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2.6 Business combinations

(IFRS 3, IAS 22, IAS 38, SIC–22, SIC–28)

Overview

IFRS 3 introduces significant changes to the accounting for business combinations discussed below (see *Forthcoming requirements*).

- **Uniting of interests accounting is allowed in limited circumstances#.**
- **The date of acquisition is the date on which effective control is transferred to the acquirer.**
- **The cost of acquisition, which is determined at the date of acquisition, is the amount of cash or cash equivalents paid, plus the fair value of the other purchase consideration given, plus any costs directly attributable to the acquisition#.**
- **When payment for a business combination is deferred, the amount payable is discounted to its present value.**
- **A liability for contingent consideration is recognised as soon as payment becomes probable and the amount can be measured reliably.**
- **The identifiable assets and liabilities, and certain restructuring provisions, are measured at fair value in the consolidated financial statements except that the portion attributable to the minority interest may be based on the acquiree's book values#.**
- **Subject to limited exceptions, adjustments to goodwill must be made by the end of the first full financial year following the acquisition#.**
- **Goodwill is capitalised and amortised over its estimated useful life which generally does not exceed 20 years#.**
- **Negative goodwill is recognised in the income statement, first to match any identified expected losses and expenses, and then over the lives of the acquired depreciable non-monetary assets. Any amount exceeding the fair value of acquired non-monetary assets is recognised in the income statement immediately#.**
- **"Push down" accounting is not used, although fair value adjustments may be recorded in the acquiree's financial statements if such revaluations are in accordance with IFRSs.**
- **When an acquisition is achieved in successive share purchases each significant transaction is accounted for separately as an acquisition#.**
- **In a uniting of interests the financial statements of the combining entities are added together for the current and all prior periods#.**
- **There is no guidance in IFRSs on accounting for common control transactions.**
- **There is no guidance in IFRSs on accounting for reverse acquisitions#.**

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Forthcoming requirements

In March 2004, the IASB issued IFRS 3 *Business Combinations* which supersedes IAS 22 *Business Combinations*. The new standard is applicable prospectively to business combinations entered into (agreement date) on or after 31 March 2004. The accounting for existing goodwill (including negative goodwill) changes from the beginning of the first reporting period beginning on or after 31 March 2004. Prospective application from an earlier date is permitted if certain criteria are met. Where an existing requirement is discussed that will be changed by the new standard, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In overview:

- IFRS 3 does not allow uniting of interests accounting. All business combinations are accounted for using the purchase accounting method;
- the cost of acquisition is the aggregate of the fair values, at the acquisition date, of the assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any costs directly attributable to the business combination;
- the cost of the business combination is allocated on acquisition to the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy recognition criteria. These items are measured at their fair value. Non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 are recognised at fair value less costs to sell (see 5.4A). Restructuring provisions are recognised only when they are the acquiree's existing liability at the acquisition date. Minority interest is measured based on the acquiree's fair value excluding goodwill;
- the time period for adjustments to goodwill is limited to 12 months from the date of acquisition;
- goodwill and certain identifiable intangibles with indefinite lives are capitalised but not amortised. An impairment test is conducted at least annually;
- when the fair value of the acquisition exceeds its cost, the acquirer must reassess the identification and measurement of identifiable assets, liabilities and contingent liabilities and recognise any remaining excess in profit or loss immediately on acquisition; and
- IFRS 3 provides guidance on accounting for reverse acquisitions.

The IASB is considering further changes to accounting for business combinations (see 2.6.8).

2.6.1 Scope

Exclusions

IAS 22.7 (1998), IFRS 3.3

IAS 22 deals with the accounting for all business combinations except:

- transactions among entities under common control; and
- interests in joint ventures and the financial statements of joint ventures (see 3.5)#.

The scope exclusion in respect of joint ventures may appear to include not only the transaction that gives rise to the joint venture (in the financial statements of both the venturer and the joint venture), but also the accounting for *any* business combination in the financial statements of a joint venture. However, in our view, the exclusion is limited to a business combination that is the creation of a joint venture, and IAS 22 should be applied to any business combination entered into by a joint venture after its formation.

Forthcoming requirements

IFRS 3.3

IFRS 3 adds two exceptions to the two discussed above:

- business combinations involving two or more mutual entities; and
- business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

These additional exemptions may be temporary, as the IASB issued an exposure draft in May 2004 which removes these exemptions (see 2.6.8).

Additionally, the new standard clarifies that the scope exclusion in respect of joint ventures only applies to the formation of a joint venture.

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The accounting for common control transactions is discussed in 2.6.6.

Identifying a business combination

Definition#

IAS 22.8 (1998)

A business combination is defined as "the bringing together of separate entities into one economic entity as a result of one entity uniting with or obtaining control over the net assets and operations of another entity".

While "entity" is not defined in IFRSs, it is clear from the definition above that the parties must comprise net assets and "operations". The acquisition of a collection of assets is not a business combination. An associated operation (e.g., a business activity) also must be acquired in order for the transaction to be a business combination. The distinction is important because no goodwill or negative goodwill arises in an acquisition of a collection of individual assets.

For example, A acquires a production plant and some inventory from B. A integrates its existing production line into the production plant, but does not take over any of the infrastructure that makes B an operation. This infrastructure includes employees, operational processes and distribution networks. In this case, we do not believe that there is a business combination in accordance with IFRSs because the exclusion of these key elements means that what is acquired does not include an ongoing operation.

However, in our view the exclusion of minor components of an operation does not preclude classification of an acquisition as a business combination if what is acquired can be considered to be an operation. For example, C acquires the operations of D except for some non-specialised staff that will transfer to D's parent entity. We believe that the exclusion of these staff, who can be replaced easily, is minor and does not impact whether an operation has been acquired.

As another example, E acquires the operations of F except for one of F's patents, which is an important part of F's operations; however, simultaneously the parties enter into an agreement that gives E the right to use F's patent indefinitely. We believe that the substance of this arrangement is that E has acquired an operation (which includes the patent), and accordingly that there is a business combination.

Forthcoming requirements

IFRS 3.14, 3.A

A business combination is defined in IFRS 3 as "the bringing together of separate entities or businesses into one reporting entity".

The above definition does not use the term 'operation' (used previously in IAS 22), but this term is used to define a 'discontinued operation' in IFRS 5 (see 5.4A). A business and an operation are distinct terms, and a business may not always be an operation and *vice versa*. A business is an integrated set of activities and assets conducted and managed for the purpose of providing:

- a return to investors; or
- lower costs or other economic benefits directly and proportionately to policyholders or participants.

A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set is presumed to be a business.

If an entity obtains control of one or more other entities that are not businesses, then the bringing together of those businesses is not a business combination. When an entity acquires a group of assets or net assets that do not constitute a business, it allocates the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the date of acquisition. No goodwill or negative goodwill is recognised.

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Substance of a transaction

In some cases it may appear that a business combination has occurred, when in fact nothing of substance has happened. For example, G is incorporated in Singapore and wishes to move its operations to Australia. G's shares are held widely and there is no controlling shareholder or group of shareholders. G incorporates a new entity H in Australia; shareholders receive one share in H for every share held in G, with the same rights and interests. Ownership of G's assets is transferred to H. The legal form of the transaction is that H has acquired the operations of G. However, in our view this transaction is a common control transaction that also is a reverse acquisition. As IFRS 3 does not provide any guidance regarding the accounting of common control transactions, it is our view that this transaction may be recognised using book values or fair values (see 2.6.6 for more details). However, in this case the transaction cannot be recognised using the fair values as the transaction is a reverse acquisition. Accordingly, the transaction will be recorded at book values, as G (in effect) has acquired itself (see 2.6.7).

2.6.2 Applicability of purchase accounting or uniting of interests accounting#

The accounting for a uniting of interests is discussed in 2.6.5.

IAS 22.13-16 (1998), SIC 9 (1998)

Almost all business combinations are accounted for as acquisitions using purchase accounting. However, in the rare case that an acquirer cannot be identified, the transaction is accounted for as a uniting of interests if all of the following criteria also are met:

- *Operations:* The combining entities share control over the whole, or effectively the whole, of their net assets and operations.
- *Management:* The management of one party is not able to dominate the selection of the management team of the enlarged entity.
- *Share-for-share:* The substantial majority, if not all, of the voting common shares of the combining entities are pooled (i.e., exchanged for shares rather than cash).
- *Relative sizes:* The fair value of one party is not significantly different from that of the other.
- *No change in interests:* The shareholders of each party maintain substantially the same voting rights and interests in the combined entity, relative to each other, after the combination as before.
- *No other financial arrangements:* Financial arrangements, taking effect either before or after the transaction, do not otherwise provide a relative advantage to one group of shareholders over the other.

If any one of the above criteria is not met, the business combination must be accounted for as an acquisition. In addition, while emphasis often is placed on the above criteria as the only tests to be met in qualifying for uniting of interests accounting, it is important to remember the overall requirement that it must not be possible to identify an acquirer.

Operations

In many cases two entities will wish to combine similar or complementary business activities. However, unless all parties to the business combination contribute the whole, or effectively the whole, of their net assets and operations, it is not a uniting of interests. For example, J and K agree to combine the whole of their retail divisions, leaving both entities with other substantial interests; since J and K do not combine the whole of their operations, the transaction is accounted for as an acquisition (assuming that the combined entity does not constitute a joint venture – see 3.5) and an acquirer must be identified.

Continuing this example, if the other interests of J and K are inconsequential to their respective operations as a whole, this would not in itself prevent a transaction from being classified as a uniting of interests since effectively the whole of their net assets and operations are combined.

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Share-for-share

SIC 9 (1998) IFRSs do not define what is meant by a "substantial majority" of the voting common shares of the combining entities. In our view, this means that at least 90 per cent of the combined number of shares should be contributed in return for shares in the combined entity.

For example, L and M agree to combine their operations; both entities have 1,000 voting common shares. All of L's shareholders will participate in the combination, and 70 per cent of M's shareholders. Effectively this means that 85 per cent of the total number of shares will be combined. In our view, this is not sufficient to conclude that a substantial majority of the voting common shares is combined. In addition, as the number of participating shareholders of one entity (in this case M) decreases, it appears that the entity with the dominant participation (in this case L) may be the acquirer.

Relative sizes

In assessing the relative fair values of the combining entities, IFRSs do not define what is meant by "not significantly different". In our view, the relative fair values should not be in a ratio greater than 55/45. In addition, in assessing the relative fair values, we believe that market capitalisation is the best measure of fair value if the shares are traded actively. If the shares are not traded actively or one entity's shares are not listed on an exchange, more emphasis should be placed on the portion that each shareholder group takes in the combined entity and any valuation reports that exist.

IFRSs do not specify the date on which the relative sizes of the combining entities should be assessed. In our view, it should be the date on which control is combined.

No change in interests

It is necessary to consider carefully the terms of the combination in assessing whether the shareholders of each entity maintain substantially the same voting rights and interests in the combined entity, relative to each other, after the combination as before. For example, N and O combine their operations and create a new entity, P. Prior to the transaction N had 500 issued shares and N's shareholders were entitled to one vote for every share held; O had 1,000 shares and O's shareholders were entitled to one vote for every share held. N's shareholders obtain 500 "A" shares in P, and O's shareholders obtain 500 "B" shares in P. The rights and interests of the A and B shares are the same except that the A shareholders are entitled to vote only when P has not met its target dividend payout ratio. In our view, this transaction should not be accounted for as a uniting of interests because the shareholders have not maintained substantially the same voting rights before and after the transaction; in this case it appears that O is the acquirer.

No other financial arrangements

A business combination may include financial arrangements that benefit one group of shareholders over another; for example, one party's share of the combined equity might depend on the post-combination performance of the business that it controlled previously. In such cases the transaction should not be accounted for as a uniting of interests.

For example, Q and R combine their operations and each group of shareholders obtains half of the shares in the combined entity. However, R's major shareholder provides a guarantee to Q's shareholders that their shares will be worth at least 5,000 in 12 months time; if they are worth less, R's major shareholder will pay the difference in cash. In our view, a guarantee of share value received by one shareholder group is inconsistent with the mutual sharing of risks and benefits that is present in a true uniting of interests; accordingly, we believe that this transaction should be accounted for as an acquisition.

Structured transactions

As noted in 2.5, a structured transaction occurs when parties to a transaction undertake a series of actions to achieve a desired outcome. In many cases it might be possible to enter into secondary

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transactions to segregate aspects of a transaction that might preclude using uniting of interests. In our view secondary transactions planned either before or after a uniting of interests transaction should be viewed as an integral part of the transaction. Secondary transactions are transactions that are planned in anticipation of the transaction, and would be expected to occur within a reasonable time period before or after the transaction.

For example, L and M agree to combine their operations; both entities have 1,000 voting common shares. All of L's shareholders will participate in the combination, but only 70 per cent of M's shareholders want to. In order to ensure that the substantial majority of the shares are combined, M's non-participating shareholders sell their shares to a third party that wishes to invest in the combined entity. Following this sale, the transaction goes ahead with all shares being combined.

In our view, the sale of the non-participating shares should be considered in assessing the transaction, which indicates that:

- the substantial majority of the voting common shares of the combining entities have not been combined because a significant shareholder interest was acquired for cash as part of the combination transaction; and therefore
- the rights and interests of the parties before and after the merger transaction, relative to one another, are not substantially the same.

IAS 22.14 (1998) The sale of a significant shareholding also raises a question about the parties' intent for a "mutual sharing of risks and benefits" in the future, which is one of the characteristics of a uniting of interests.

Our analysis of this transaction would not change even if M's non-participating shareholders sold their shares to other shareholders of M because the rights and interests of the individual shareholders change as part of the transaction.

Forthcoming requirements

IFRS 3.14 Under IFRS 3 all business combinations are accounted for using the purchase method. The uniting of interests method that was allowed in limited circumstances cannot be used for transactions which have an agreement date later than 31 March 2004.

2.6.3 Purchase accounting

Identifying the acquirer

IFRS 3.20 In most acquisitions identifying the acquirer will be straightforward because it will be clear that one entity took control of the operations of another entity. However, in some cases when shares are issued in order to pay for the acquisition, the process of identifying an acquirer may be more complex. Under IFRSs if the fair value of one entity is significantly greater than that of the other, the larger entity is the acquirer; or if one entity can dominate the selection of the management team of the combined entity, the dominant entity is the acquirer#.

Forthcoming requirements

IFRS 3.17-23 IFRS 3 requires that an acquirer be identified for all business combinations. An acquirer is the combining entity that obtains control of the other combining entities or businesses.

The relationship between the combining entities and / or businesses determines which entity obtains control (i.e., which entity has the power to govern the financial and operating policies of the other entity or business so as to obtain benefits from its activities).

Reverse acquisition

A reverse acquisition may occur when an entity issues shares in return for acquiring the shares in another entity#. For example, S acquires 60 per cent of the shares in T. As consideration S issues its own shares to T's shareholders; however, S issues so many shares that T's shareholders obtain an

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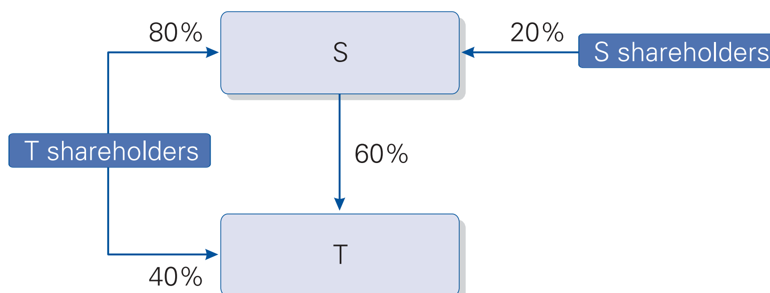
80 per cent interest in S. In this case all of the elements of control should be analysed (see 2.5) to determine which entity is the acquirer. If the conclusion is that T is the acquirer for accounting purposes, then the transaction is referred to as a reverse acquisition. In this case S will be the legal parent and accounting subsidiary, and T will be the legal subsidiary and accounting parent.



The accounting for reverse acquisitions, and related financial reporting issues, are discussed in 2.6.7.

Forthcoming requirements

IFRS 3.21 IFRS 3 requires that the acquirer is identified on the basis of control in all cases. In order to identify the acquirer, the relationship between the combining entities is considered. IFRS 3 acknowledges that the acquirer may be the legal subsidiary in some cases (i.e., a reverse acquisition).

Creation of a new entity

In some cases a new entity will be formed, which will acquire the shares or net assets of two other entities. Often this occurs because the new entity will be listed. For example, V wishes to acquire the retail operations of W and then list the combined retail operations. V forms a new entity X into which it transfers its own retail operations; X then acquires W's retail operations. Looking at the legal form of the transaction it appears that X has made two acquisitions, the retail operations of V and W, both of which should be treated as acquisitions. However, in our view, only the retail operations of W have been acquired. In substance the new entity X is an extension of V, created in order to hold its retail division#. This is discussed further below under 2.6.6.

Forthcoming requirements

IFRS 3.22, 23 Under IFRS 3, when a new entity is created to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination is identified as the acquirer.

Date of acquisition

IFRS 3.25, 3.A The date of acquisition is the date on which control is transferred to the acquirer, which will depend on the facts and circumstances of each case. Determination of the date of acquisition is important because it is only from that date that the results of the subsidiary are included in the consolidated financial statements of the acquirer; it also is the date on which the fair values of assets and liabilities acquired, including goodwill, are measured#. The date of acquisition is based on the substance of the transaction rather than its legal form.

Forthcoming requirements

IFRS 3.A Under IFRS 3, when a business combination is achieved in a single exchange transaction, the date of exchange is the acquisition date. When a business combination involves more than one exchange transaction, for example, when it is achieved in stages by successive share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer. The date of exchange is used to determine the cost of the acquisition and goodwill associated with the transaction.

Under IFRSs, unlike some other GAAPs, it is not possible to designate an effective date of acquisition other than the actual date that control is transferred. However, in some cases it may be

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acceptable for an acquirer to consolidate a subsidiary from a period end date close to the date of acquisition for convenience, as long as the effect thereof is immaterial (see 1.2). For example, a subsidiary acquired on 13 October might be consolidated with effect from 30 September if the effect of the 13 days is not material.

Backdated agreements

In some cases an agreement will provide that the acquisition is effective on a specified date. For example, Y and Z commence negotiations on 1 January 2003 for Y to acquire all of the shares in Z. On 1 March 2003 the agreement is finalised and Y immediately obtains the power to control Z's operations. The agreement states that the acquisition is effective as of 1 January 2003 and that Y is entitled to all profits after that date; the purchase price is determined by reference to Z's net asset position at 1 January 2003.

In our view, notwithstanding that the price is based on the net assets at 1 January and Z's shareholders do not receive any dividends after that date, the date of acquisition for accounting purposes is 1 March 2003.

Control and benefits

In determining the date of acquisition, it is important to remember that the definition of control has two elements – the power to govern the financial and operating policies – so as to obtain benefits (see 2.5). Both of these elements must be met at the date of acquisition.

For example, A contracts with vendor V to purchase the shares in B. The contract is entered into on 15 September 2003. The contract provides that V will deliver to A its shareholding in B on 1 January 2004 and A will pay the agreed purchase price. The purchase price is a fixed sum plus the excess (or less the deficit) of the actual net asset value at 31 October 2003, over an estimated net asset value specified in the contract. As from 15 September 2003 A is able to run B as it desires, but is prohibited from arranging dividend payments out of B.

A is able to govern B from 15 September 2003. However, it does not benefit from B's activities before 31 October 2003 since A pays V for any additional profits made between 15 September and 31 October (or is reimbursed for any losses). Accordingly the date of acquisition is 31 October 2003.

Shareholder approval

In some cases management may agree an acquisition subject to receiving shareholder approval (sometimes referred to as a "revocable" agreement). For example, entity C enters into an agreement with the shareholders of entity D on 1 March 2003 to acquire a controlling interest in entity D. The agreement provides that the effective date of transfer is 1 January 2003 and is subject to approval by the shareholders of entity C at a meeting scheduled for May 2003. In our view, usually the date of acquisition cannot be prior to C's shareholders approving the transaction because the passing of control is conditional upon their approval. However, it is necessary to consider the substance of the requirement of the shareholder approval to assess the impact it has obtaining the power to control.

Regulatory approval

In some cases a business combination cannot be finalised prior to regulatory approval being obtained. Although at the date of acquisition the acquirer must have the ability to govern the financial and operating policies of the acquiree, it is not necessary for the transaction to be finalised legally. It is necessary to consider the nature of the regulatory approval in each case and the impact that it has on the passing of control.

For example, E and F are manufacturers of electronic components for a particular type of equipment. E makes a bid for F's business and the competition authorities announce that the proposed transaction is to be scrutinised as it may violate competition laws given that E and F are two of the

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dominant entities in this sector. E and F agree the terms of the acquisition and the purchase price, but the contracts are made subject to competition authority clearance. In this case the date of acquisition cannot be earlier than the date that approval is obtained from the competition authority since this is a substantive hurdle that must be overcome before E is able to control F's operations. In another example G acquires the shares in H on 1 April 2003 and takes control of H's operations. However, before the sale of shares becomes binding legally, the transaction must be registered, a process that takes up to six weeks. The registration of the shares is a formality and there is no risk that the sale could be rejected. In this case the date of acquisition is 1 April 2003 since the registration of the sale does not prevent the passing of control. If the facts of this case were different and the registration was not merely a rubber-stamp process because the authorities were required to consider and accept or reject each transaction, it is likely that the date of acquisition could not be earlier than the date of registration.

Public offers

When a public offer is made for the acquisition of shares, it is necessary to consider the nature and terms of the offer and any other relevant laws or regulations. For example, J makes an offer to acquire all of the shares in K and each shareholder can decide individually whether to accept or reject the offer; the offer is conditional on at least 75 per cent acceptance. The offer is made on 15 September 2003 and the offer closes on 15 November 2003, at which time ownership of the shares will be transferred. At 20 October 2003 enough offers have been accepted to give J its minimum 75 per cent of the shares of K.

Whether or not J has the power to control K at 20 October 2003 will depend on the local laws and regulations in respect of public offers. In our experience it is probable that J does not have the power to control K's operations until the public offer has closed and J is able to make decisions and impose its will on K's operations; if this is indeed the position, it means that the date of acquisition could not be earlier than 15 November 2003.

In some countries an offer, at a certain minimum price, to buy the shares of all other shareholders must be made once a shareholder owns a certain percentage of the voting rights in an entity (a "mandatory offer"). Typically the acquirer obtains the power to control the voting rights associated with each share as each individual shareholder accepts the offer.

Acquirer consulted on major decisions

In some cases the seller in a business combination agrees to consult the acquirer on major business decisions prior to completion of the transaction. The requirement to consult the acquirer does not mean necessarily that control of the operations has passed to the acquirer from this time. It is necessary to consider all the relevant facts and circumstances to determine the substance of the agreement between the parties.

For example, L makes an offer to buy all of the shares in M, which is wholly owned by N. The offer is subject to the satisfactory completion of due diligence. In the meantime the parties agree that L should be consulted on any major business decisions. In our view, L does not have the power to govern M simply because it will be consulted on major decisions; L does not have the ability to do whatever it likes with M's business and the due diligence is yet to be completed.

Cost of acquisition

IFRS 3.24, 3.A

The cost of acquisition is the amount of cash or cash equivalents paid, plus the fair value of the other purchase consideration given, plus any costs directly attributable to the acquisition. The cost of acquisition, including the fair value of any securities issued, is determined at the date of exchange, which generally is the date that control is obtained.

IFRS 3.24, 3.A

If the business combination is achieved in stages, the cost of the business combination is determined at the date of *each* exchange transaction. For example, when it is achieved in stages by successive

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share purchases, the date of exchange is the date that each individual investment is recognised in the financial statements of the acquirer (see 2.6.4).

The cost of an acquisition relates only to cost incurred to obtain control over the acquiree. If other costs are incurred, they should be accounted for in accordance with the requirements of other applicable IFRSs. However, in some cases it may be difficult to determine what a payment is for, particularly when the recipient is a shareholder *and* a continuing employee of the acquiree.

Factors to consider include whether the payment is linked to future services and / or performance; whether repayment is required if the employee leaves the entity within a specified period; the length of any required employment period; equivalent payments received by shareholders who do not become employees; and the formula used to determine the amount of the payment. It also is important to understand the role of the employee within the organisation, the nature of the services they provide, and the reasons for the payment.

Forthcoming requirements

IFRS 2.5

In February 2004, a new standard (IFRS 2) was issued to provide guidance on accounting for share-based payment transactions. IFRS 2 states that share-based payment transactions in which the entity acquires goods as part of the net assets acquired in a business combination should be accounted for under IFRS 3. However, a share-based payment transaction to employees of the acquired entity in return for continued service should be accounted for under IFRS 2 (see 4.5A).

When employees also are shareholders, judgement is required to determine whether a share-based payment transaction represents an additional cost for the acquired entity (a form of contingent consideration) or payment for future services. IFRSs have no specific guidance on this matter. In our view, guidance based on United States practice may be useful. US GAAP (EITF 95-8) identifies factors to be considered including:

- Factors involving terms of continuing employment:
  - *Linkage of continuing employment and contingent consideration* – an arrangement in which the payments automatically are forfeited if employment terminates is a strong indicator that the arrangement is compensation for post-combination services. Arrangements in which the payments are not affected by employment may indicate that the payments are additional purchase price.
  - *Duration of continuing employment* – if the length of time of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.
  - *Level of compensation* – situations in which employee compensation other than the contingent payments is at a reasonable level compared to that of other key employees in the combined entity may indicate that the contingent payments are additional purchase price rather than compensation.
- Factors involving the composition of shareholder groups:
  - *Relative amounts of consideration* – if selling shareholders who do not become employees receive lower contingent payments on a per-share basis from payments received by the selling shareholders who become employees of the combined entity, this may indicate that the incremental amount per share of contingent payments to the selling shareholders who become employees is compensation.
  - *Relative relationships* – the relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if selling shareholders who owned substantially all of the shares of the acquired entity continue as key employees; this may be an indication that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a minor number of shares of the acquired entity and

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all selling shareholders receive the same amount of contingent consideration on a per-share basis, this may indicate that the contingent payments are additional purchase price.

- *Pre-acquisition ownership interests* – the pre-acquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

Understanding the reasons why the acquisition agreement includes contingent payment terms may be helpful in assessing the substance of the arrangement. For example, if the initial consideration paid at the acquisition date is based on the low end of a range established in the valuation of the acquired entity and the contingent formula relates to that valuation approach, that may suggest that the contingent payments are additional purchase price. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that may suggest that the substance of the arrangement is to provide compensation.

Fair value of securities issued

IAS 39.48, 49

When shares are issued as consideration, IAS 22 and SIC–28 are silent in respect of the exact share price to be used in determining fair value; in our view, it should be the current bid price, which is consistent with the guidance in IAS 39 for measuring the fair value of financial instrument assets (see 3.6).

IAS 19.145

Securities issued may include share options. Although IAS 19 does not specify recognition and measurement requirements for equity compensation benefits, this exclusion applies only in the context of benefits paid to employees#. There is no similar exemption in respect of shares or share options issued as consideration for obtaining control in a business combination. In our view, shares issued as consideration in an acquisition should be measured at fair value. In our view, in the absence of an observable market price, the fair value of share options should be determined using a suitable option-pricing model.

Forthcoming requirements

IFRS 2.5

IFRS 2 introduces requirements for the recognition and measurement of equity compensation with effect from 1 January 2005 (see 4.5A). Equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of IFRS 2; instead they must be accounted for as consideration paid in a business combination. However, equity instruments granted to employees of the acquiree in their capacity as employees are within the scope of IFRS 2, even if they are granted at the date control passes in a business combination.

IFRS 3.27, IAS 39.48, 49

When the securities issued are listed, the quoted price at the date of acquisition is used to determine the cost of acquisition except in "rare circumstances" when the quoted price is considered to be unreliable. However, before using an alternative measure of fair value *both* of the following conditions must be met:

- the quoted price must be considered unreliable either because it has been affected by undue price fluctuations or because of the narrowness (or thinness) of the market; and
- it must be demonstrated that the alternative measure of fair value is a more reliable fair value.

In our view, the above criteria are very difficult to meet and in almost all cases the quoted share price will be used to determine the cost of acquisition.

IFRS 3.27

Even though the sale of a large block of shares may result in a discount or premium to the quoted price, use of the actual quoted price is required. Accordingly any potential discount or premium is ignored.

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When a new entity is formed for the purpose of listing subsequent to the business combination, judgement is required to assess whether the share price used in determining the cost of acquisition should be that of the newly listed entity.

IFRS 3.27 For example, unlisted entity N acquires O's operations in return for issuing shares to O's shareholders; N lists some months later, which was planned at the time of the acquisition. In valuing the shares issued there are two choices:

- using the share price of N once listed; or
- on the basis that the acquirer is not listed, estimating the fair value by reference to either the proportional interest in the fair value of N's operations obtained by O's shareholders, or the proportional interest in the fair value of O's operations acquired.

In our view, it is preferable, in this example, to determine the fair value of the shares issued by reference to the fair value of either N's or O's operations; since a number of months pass prior to N being listed, the eventual share price is not clearly that of the acquirer at the date of acquisition. However, we believe that N's post-float share price should be considered if N lists within a short period after the acquisition because it provides relevant and objective information about the value of the consideration given to O's shareholders.

Liabilities incurred or assumed

Forthcoming requirements

IFRS 3.28 Under IFRS 3, the cost of a business combination includes liabilities incurred or assumed by the acquirer in exchange for control of the acquiree. Future losses or other costs expected to be incurred due to the acquisition are not part of the cost of the business combination as they are not liabilities (see 3.11).

Directly attributable costs

IAS 22.25 (1998), 39.66 (2000) Costs directly attributable to the acquisition include professional fees as well as the cost of issuing equity securities#, but exclude the costs of issuing debt, which are deducted from the debt's carrying amount.

Forthcoming requirements

IFRS 3.29-31 Under IFRS 3, the costs of issuing equity securities no longer may be included as part of the cost of a business combination.

IFRS 3.29 Internal costs are included to the extent that they can be attributed directly to the particular acquisition. The cost of maintaining an acquisitions department cannot be capitalised because the work of the department is not directed at a specific acquisition; rather, it is regarded as a general administrative cost. There is no requirement for the directly attributable costs to be incremental. For example, a member of an entity's accounting team is assigned to work full-time on determining the fair values of the assets and liabilities of an acquiree for a period of six weeks prior to the date of acquisition. In our view, the acquirer may include the cost of the employee's benefits for that six-week period in the cost of acquisition even though that salary cost would have been incurred regardless of the acquisition. However, in practice the determination of the cost of acquisition often reflects only external costs.

IFRS 3.29 IFRSs refer to the cost of acquisition being incurred by the acquirer. In our view, costs incurred by the acquiree should not be capitalised unless the acquirer reimburses the acquiree for them.

In some cases the acquirer may employ a "finder" to identify potential acquisition targets. If the finder is employed by the acquirer to find a target, in our view, the finder's fee should be expensed, because it does not relate to a specific acquisition and is similar to the cost of maintaining an acquisitions department. If the acquiree employs the finder and the acquirer pays the fee *only* if the

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deal goes through, then we believe that the fee should be capitalised as part of the cost of acquisition. However, if the acquirer pays the fee regardless of whether the deal goes through, then we believe that the fee should be expensed as incurred.

IAS 23.6 Interest incurred on a loan obtained for the purpose of acquiring a subsidiary cannot be capitalised since IFRSs do not allow borrowing costs attributable to an investment (other than investment property) to be capitalised.

Transaction costs are capitalised gross of any related deferred tax, which is accounted for separately (see 3.12).

Deferred consideration

IFRS 3.26, IAS 39.AG64 When payment in a business combination is deferred, the amount payable is discounted to its present value. However, the discount rate to be used is not specified. In our view, the amount payable falls within the scope of IAS 39 and should be discounted using a market rate of interest for a similar instrument of an issuer with a similar credit rating (see 3.6).

Contingent consideration

IFRS 3.32 A liability is recognised for contingent consideration as soon as payment becomes probable and the amount can be measured reliably. The purchase price subsequently is adjusted against goodwill or negative goodwill as the estimate of the amount payable is revised.

IFRS 3.33, 34, 63 There is no time limit on the adjustment of contingent consideration. Adjustments may arise as a result of changes in estimates, or when an amount becomes probable and can be measured reliably.

IFRS 3.33 Although IFRSs refer to the reliable measurement of contingent consideration, often it will not be possible to determine the exact amount of contingent payments with certainty (e.g., if the contingent payment is a percentage of future profits). However, IFRSs accept that there will be some uncertainty and conclude that this uncertainty does not impair the reliability of the information. For example, P acquires Q's operations and pays 120,000 up-front. P also agrees to pay an additional amount equal to five per cent of the first year's profits following the acquisition. Q historically has made profits of 20,000 to 30,000 each year, and P expects profits of at least 20,000 in the first year, which means that an additional payment of 1,000 would be required. Accordingly, the 1,000 should be recognised immediately as a liability and additional purchase price since the payment is probable even though the exact level of future profits is uncertain.

Continuing this example, suppose that the contingent payment is five per cent of the first year's profits that are in excess of those being earned currently by Q. In this case P's forecasts and plans, as well as industry and growth trends, would be considered in assessing whether excess profits are probable.

Care should be taken to ensure that amounts characterised as contingency payments are actually contingent rather than representing either deferred consideration that should be recognised immediately (see *Deferred consideration* above) or payments for other reasons related to ongoing operations that should be expensed as incurred (see above).

For example, R acquires S's operations and pays 100,000 up-front. R also agrees to pay an additional amount that is the higher of 2,000 and five per cent of the first year's profits following the acquisition. In this case the minimum additional amount payable is 2,000, which is known. Accordingly, the amount should be recognised as deferred rather than contingent consideration. In addition, R should assess whether any additional amount of contingent consideration is probable.

IFRSs are silent on whether contingent consideration should be discounted in the same way as deferred consideration. In our view, when the payment of contingent consideration is deferred, any

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amount recognised should be discounted to its present value. The purchase consideration is not adjusted for the subsequent effect of any discounting; instead unwinding of the discount is recognised as an interest expense.

IAS 22.67 (1998), SIC 22.5, 6 (1999)

When contingent consideration is recognised or adjusted after the date of acquisition, the amount of the purchase price, including goodwill, will change. This raises the question of whether goodwill amortisation should be recalculated retrospectively (with the cumulative adjustment being recognised in the current period) or prospectively#. SIC–22 requires that goodwill is recalculated retrospectively when an adjustment is made to the fair values of identifiable assets and liabilities. However, IFRSs are silent as to the treatment of an adjustment to *consideration*. In our view, either treatment (retrospective recalculation of goodwill as described in SIC–22 or prospective adjustment of goodwill) is acceptable and an entity should make an accounting policy election in this regard, which is applied consistently to all acquisitions.

These requirements apply equally to contingent consideration payable in the form of shares. However, when shares are issued subsequent to the date of acquisition, it is not clear whether the share price used to measure the additional consideration should be that at the date of acquisition or at the date that the shares are issued. In our view, either treatment is acceptable as long as the entity makes an accounting policy election in this regard, which is applied consistently to all acquisitions.

Forthcoming requirements

IFRS 3.54, 55

Under IFRS 3, after initial recognition goodwill and certain other intangibles with indefinite lives are measured at cost less accumulated impairment charges, and are not amortised. Goodwill is adjusted for changes to the estimate of contingent consideration recognised. Therefore, the issue of retrospective or prospective treatment of the change in consideration is not relevant.

Contingent consideration in the financial statements of the seller

IAS 37.1, 10, 33

In our view, contingent consideration in the financial statements of the seller should be accounted for in accordance with IAS 37; it is not excluded from the scope of that standard. Accordingly, we believe that the seller should account for contingent consideration as a contingent asset, since the amount represents a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of uncertain future events. This means that the seller will recognise contingent consideration only when payment becomes virtually certain (see 3.11).

Payments as a guarantee of value

IFRS 3.35

Any payments made by the acquirer under a guarantee of the value of its shares or debt issued as consideration do not increase the cost of acquisition. If equity instruments are issued, the debit side of the entry is to equity, thus reducing the premium in respect of the share issue for the acquisition. If debt instruments are issued no accounting entry is necessary since both the debit and credit side of the entry are to the liability. However, this has the effect of increasing the discount on initial recognition (or reducing any premium) because the face value of the liability would have increased, which will be made up over the life of the debt using the effective interest method (see 3.6).

Fair value of assets and liabilities acquired#

IAS 22.32, 35 (1998)

The identifiable assets and liabilities of the acquiree that existed at the date of acquisition, plus certain restructuring provisions, are recognised in the consolidated financial statements and measured at fair value, except that the portion attributable to the minority interest may be based on the acquiree's book values# (see 2.5). This is an accounting policy election that should be applied consistently to all acquisitions.

For example, T acquires 80 per cent of the shares in V. V's assets include property with a carrying amount of 100 and a fair value of 150. If the assets are recognised at full fair value in the consolidated financial statements, the carrying amount of the property will be increased by 50 with 10 of that increase being credited to minority interests. The 10 represents the minority share of the

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increase in the value of the property (50 x 20 per cent). If the portion attributable to the minority interest is based on the acquiree's book values, the property will have an initial carrying amount of 140 in the consolidated financial statements (150 x 80 per cent + 100 x 20 per cent).

Forthcoming requirements

IFRS 3.36, 37 Under IFRS 3, the acquirer recognises not only the acquiree's identifiable assets and liabilities at their fair value but also any acquired *contingent liabilities*. Further, subsidiaries and certain other assets (or asset groups) acquired solely with the intention of disposal in the short term are consolidated but are classified as non-current assets (or disposal groups) held for sale. Assets held for sale are measured at fair value less costs to sell (see 5.4A). Liabilities in respect of restructuring the acquired businesses are recognised if, and only if, the acquiree has an existing liability at the acquisition date (see below).

IFRS 3.40 Under IFRS 3 if the acquirer does not obtain all of the ownership interests in the acquiree, the minority's portion of the recognised fair value of the acquiree's identifiable assets, liabilities and *contingent liabilities* is assigned to minority interest. An entity no longer is permitted to measure the minority interest based on the historical cost of the acquired entity.

Consequently, in the above example, assuming that no contingent liabilities exist, the minority interest in respect of the property must be measured at 30 (150 x 20 per cent).

IAS 22.29, 30 (1998) The liabilities recognised as part of the purchase accounting generally exclude those that arise from the acquirer's intentions or future actions. They also exclude future losses and other costs that will be incurred as a result of the acquisition. As an exception a restructuring provision may be recognised if certain strict criteria are met (see below)#.

Forthcoming requirements

IFRS 3.41 Under IFRS 3, restructuring liabilities are recognised on acquisition only when they represent a liability recognised under IAS 37 (see 3.11) by the acquiree at the acquisition date. An acquiree's restructuring plan that is conditional upon it being acquired is not, immediately before the business combination, a present obligation of the acquiree nor is it a contingent liability.

IFRS 3.B16, 17 IFRSs provide general guidelines on the determination of fair values for various assets and liabilities. This section discusses some of the problematic issues that may arise.

IAS 12.15, 19, 24 (2000) To the extent that the fair value adjustments recognised as part of the purchase accounting give rise to temporary differences, deferred tax is recognised. However, deferred tax in respect of goodwill is not recognised unless the goodwill is tax deductible. To the extent that the negative goodwill is deferred and amortised, deferred tax in respect of negative goodwill is not recognised#. The recognition of deferred tax in respect of business combinations is discussed in more detail in 3.12.

Forthcoming requirements

IAS 12.24 Under IFRS 3 negative goodwill is recognised in the income statement immediately. As a result, IAS 12 was amended to prohibit recognition of a deferred tax asset relating to negative goodwill. This amendment of IAS 12 must be applied when, and only when, an entity adopts IFRS 3 (see 3.12).

General recognition and measurement requirements#

IAS 22.26, 27 (1998) In determining whether an asset or liability should be recognised as part of the purchase accounting, IAS 22 refers to the assets and liabilities of the acquiree that existed at the date of acquisition. The standard acknowledges that the items may not have been recognised previously by the acquiree, for example, because the recognition criteria of a specific standard were not met. This indicates that the recognition criteria should be assessed from the point of view of the acquirer and the larger group. However, in assessing the criteria from the acquirer's point of view, care should be taken not to take account of the acquirer's intentions or future actions.

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Forthcoming requirements

IFRS 3.36, 37, IAS 12.67

Identifiable assets, liabilities and contingent liabilities are recognised only if they satisfy initial recognition criteria set out in IFRS 3. The recognition criteria in IFRS 3, generally are consistent with the "regular" recognition criteria in other standards (i.e., the criteria that would apply if the asset or liability was acquired or incurred outside of a business combination). However, special criteria are included in respect of intangible assets and contingent liabilities that may result in assets and liabilities being recognised as acquired items that would not be recognised if acquired outside of a business combination. If, as a result of the business combination, it becomes probable that the acquirer will recover its own deferred tax asset that was not recognised previously, recognition of the deferred tax asset is not included in the initial accounting for the business combination and instead it is recognised in the income statement (see *Deferred tax assets* below).

Inventories of finished goods and work-in-progress

IFRS 3.B 16(d)

Inventories of finished goods are valued at selling prices less the costs of disposal and a reasonable profit margin for the selling effort of the acquirer. Similarly, inventories of work-in-progress are valued at selling prices less the costs to complete, including the costs of disposal and a reasonable profit margin for the completion and selling effort of the acquirer.

Judgement is required in determining a reasonable amount of profit attributable to the effort incurred by the acquiree pre-acquisition, and the profit attributable to the effort that is likely to be incurred by the acquirer post-acquisition. In our view, the analysis should take into account the current profitability of the product at the date of acquisition, even if conditions were different when the inventory was manufactured.

For example, the acquiree has finished goods measured at a cost of 100; the expected selling price is 150. The inventory is specialised and there are very few potential customers; this inventory already has been earmarked for one of those customers. Distribution costs are estimated at 20. In the absence of any additional factors, in our view, the fair value of the inventory would be close to 130 (150 - 20) because the selling effort to be incurred by the seller is minimal.

Land and buildings

IFRS 3.B 16(e)

Land and buildings are required to be stated at market value. Although not defined specifically for the purpose of accounting for a business combination, market value has a similar meaning to fair value but in the context of an active market. This means that disposal costs are not deducted in determining fair value.

In our view, market value is the price that could be obtained for the land and buildings, without regard to their existing use. For example, an acquiree owns offices situated in a prime residential location. The value of the property as residential real estate exceeds its value as an office building. Accordingly, market value should be determined based on its value as residential real estate (see also 3.2 for further discussion about determining the fair value of property).

Intangible assets

IAS 38.8-16, 31 (1998)

As noted above, in order to recognise an intangible asset separately from goodwill, it should meet the definition and recognition criteria in IAS 38. In order to meet the definition of an intangible asset the item must be identifiable# and the entity must have control over it.

Forthcoming requirements

IFRS 3.46

The revised IAS 38 clarifies how to assess the identifiability of an intangible asset, whether acquired in a business combination or otherwise. An intangible asset is considered identifiable if it arises from contractual or legal rights or is separable.

In our experience, many of the issues encountered in this area concern the control test. For example, in our view an acquiree's workforce generally cannot be recognised as a separate asset because

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there is insufficient control. The same applies to assets such as customer relationships# and market share. In contrast, a customer list is controlled by the entity and should be valued as part of the purchase accounting if it could be sold to third parties. In this regard, it is important to ensure that the valuation performed is of the list itself, and does not include any value in respect of the customer relationship.

Forthcoming requirements

IAS 38.16, IFRS 3.IE B The revised guidance in IFRS 3 on recognition of acquired intangibles notes that customer relationships may qualify for recognition if exchange transactions (other than as part of a business combination) for similar relationships provide evidence of control and of identifiability (i.e., through separability), even if the acquired customer relationships do not arise from contractual or legal rights.

IAS 38.31, 42, 43 (1998) An acquiree's research projects in progress should not be recognised separately since IAS 38 presumes that the recognition criteria for intangible assets are not met (i.e., the probability of receiving future economic benefits cannot be demonstrated at the research stage of a project)#. Similarly, an acquiree's development projects in progress should be recognised separately only if the specific capitalisation criteria in IAS 38 are met (see 3.3). In assessing these criteria, they should be considered from the point of view of the acquirer and the enlarged group.

Forthcoming requirements

IFRS 3.45, IAS 38.34, 35, 42, 43 As a result of the revisions made to IAS 38 in connection with IFRS 3, it is more likely that an entity will be required to recognise an acquired intangible asset for an in-process research or development project (IPR&D). IFRS 3 requires IPR&D that meets the definition of an intangible asset, and can be measured reliably, to be recognised separately from goodwill and capitalised and amortised as an intangible asset with a finite life. The fair value of an intangible asset acquired in a business combination normally can be measured reliably.

IFRS 3.B16(g), IAS 38.78 In most cases the fair value of an intangible asset cannot be determined by reference to an active market because it is unique; examples include trademarks, brands and newspaper mastheads. As a result, the fair value of many acquired intangibles will have to be measured based on valuations that estimate what the asset would cost on an arm's length basis.

IAS 22.40 (1998) In such cases the fair value of the intangible asset is limited to an amount that does not create or increase negative goodwill#.

Forthcoming requirements

IFRS 3.B16(g) Under IFRS 3 there is no limit on the fair value of an acquired intangible related to the amount of negative goodwill recognised.

Goodwill recognised by the acquiree prior to the date of acquisition is not an identifiable asset of the acquiree when accounting for the business combination.

Valuation of an acquiree's investment in an associate

Goodwill attributable to an investment in an associate is included in the carrying amount of the associate (see 3.5). Accordingly, when an entity acquires a group that includes an investment in an associate accounted for under the equity method, the goodwill attributable to the associate should be identified separately and measured at the date of the business combination based on the total purchase price paid for the group.

For example, W acquires X, whose assets include an investment in associate Y. In our view, W should determine the cost of acquisition for Y as part of the purchase price allocation. W would measure the fair value of the acquired investment in Y as if W had acquired this investment in an associate directly. Any difference between the fair value of the investment in Y at the date that W acquired X and X's book value of the investment in Y is a purchase price adjustment recognised on

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consolidation. This purchase price adjustment may result in recognition in W's consolidated group financial statements of goodwill related to Y. This goodwill is included as part of the investment in X in the W group consolidated financial statements. However, it is measured as goodwill (see 3.5).

Deferred tax assets

IFRS 3.B16(i)

Deferred tax assets are recognised at the probable amount of the tax benefit that will be recovered, assessed from the point of view of the acquirer and the enlarged group. The general recognition and measurement guidance of IAS 12 is applied to determine which deferred tax assets are probable of recovery (see 3.12). The assessment includes deferred tax assets of the acquirer that were not recognised previously, but which probably will be recovered as a result of the business combination#.

Forthcoming requirements

IAS 12.67

Under the revised IAS 12, deferred tax assets of the acquirer must be recognised if their recovery becomes probable due the business combination. However, the revision of that estimate of recovery is not part of the purchase price allocation, and instead is recognised in the income statement.

Defined benefit plans

IFRS 3.B16(h), IAS 19.108

Pension surpluses (to the extent recoverable) and deficits are recognised at the full present value of the obligation less the fair value of any plan assets (i.e., all actuarial gains and losses and past service costs are recognised – see 4.4). In our view, the valuation should be performed using actuarial assumptions that are appropriate to the acquirer (without taking into account the acquirer's intentions or future actions, such as an intention to change the terms of the plan to conform to the acquirer's existing plan); this is consistent with the general requirement to assess the recognition criteria from the point of view of the acquirer (see above).

Modification of employee benefits triggered by the acquisition

IAS 22.29 (1998)

In some cases a pre-existing employee contract may provide that the employee is entitled to an additional benefit if there is a change of control. For example, a key executive's contract may provide that he or she will receive a lump sum payment if the entity is taken over. IAS 22 is silent as to whether such benefits are recognised as an assumed liability as part of the purchase accounting. In our view, an entity should recognise an assumed liability on the basis that this pre-existing contingent liability becomes an actual liability at the moment that the acquisition occurs and therefore requires recognition#.

Forthcoming requirements

IFRS 3.42

Under IFRS 3, a payment that an entity is contractually required to make in the event of a business combination is a contingent liability of that entity. The business combination makes an outflow of resources to settle the obligation probable. Therefore, a liability is recognised as an identifiable liability on acquisition.

IFRS 3.42

The above example should be distinguished from the situation where the acquirer decides to alter an employees' contract on its own initiative. For example, a number of the acquiree's employees are entitled to a company car. The acquirer renegotiates the contracts and the employees receive a lump sum cash bonus in lieu of the car scheme, which is terminated. No liability in respect of the lump sum payment should be recognised as part of the purchase accounting since it results from a post-acquisition action by the acquirer.

Liability for which there is no known exposure

In some cases, an entity that makes regular acquisitions in a particular industry may know, based on its past experience, that further liabilities always arise after the initial fair values have been assigned, and it may be able to estimate the amount of further liabilities that are likely to arise. However, unless a specific exposure can be identified at the date of acquisition, no additional liabilities should be recognised in the initial purchase accounting#.

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An adjustment might be made to the purchase accounting if subsequent evidence shows that a liability did indeed exist at the date of acquisition (see below under *Fair value adjustments*).

Forthcoming requirements

IFRS 3.47-50 IFRS 3 requires contingent liabilities to be recognised at their fair value on acquisition. The situation described above could be an indicator of the existence of contingent liabilities that must be recognised as acquired obligations (see below). However, a general provision on the basis that it is probable that contingent liabilities will be identified in the future cannot be recognised under IFRS 3.

Operating leases#

IAS 22 is silent on the recognition of favourable or unfavourable operating leases as an identifiable asset or liability separate from goodwill. For example, an entity may have entered into a lease agreement in the past that is now at a substantial discount to market rates. In our view, an entity may make an accounting policy election, which should be applied consistently to all acquisitions, either:

- to recognise an asset or liability in respect of operating leases on the basis that at the date of acquisition a portion of the purchase price was in respect of the off-market lease and represents a lease prepayment or payable from the point of view of the acquirer; or
- to not recognise any asset or liability on the basis that the accounting for operating leases is governed by IAS 17, which does not provide for any intangible asset to be recognised in respect of the lease agreement itself.

However, if an acquired lease is onerous (e.g., for office space that will not be used and cannot be sublet) then an onerous contract would exist, and a provision under IAS 37 would be recognised on acquisition.

Forthcoming requirements

IFRS 3.IE D IFRS 3 states that a favourable operating lease contract is an identifiable intangible asset with a fair value above zero. Therefore, the acquired intangible must be recognised separately.

Government grants

The acquiree may have received a government grant that has been either deducted from the cost of the related asset or recognised separately as deferred income (see 4.3). In our view, any remaining unamortised portion of the government grant should not be recognised as part of the purchase accounting:

- If the government grant was deducted from the carrying amount of the related asset, the asset will be recognised at fair value and there is no basis in IFRSs for the unamortised portion of the grant to be deducted from that fair value.
- If the government grant was recognised as deferred income, the amount does not meet the definition of a liability and therefore should not be recognised as part of the purchase accounting.

Contingent liabilities and assets

IAS 37.13 Contingent liabilities should not be recognised as part of the purchase accounting because they do not meet the criteria for recognition as liabilities set out in IAS 37#. For example, at the date of acquisition the acquiree is subject to legal action by a disgruntled customer. The acquiree regarded the legal action as trivial and did not recognise a liability since payment was not considered probable. At the date of acquisition the acquirer concurs with the judgement of the acquiree. Accordingly, no liability is recognised as part of the purchase accounting.

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Forthcoming requirements

IFRS 3.47-50 IFRS 3 requires contingent liabilities to be recognised at fair value on acquisition. If, after initial recognition, the contingent liability becomes a current obligation, and the provision required under IAS 37 (see 3.11) is higher than the fair value recognised at acquisition, the liability is increased with any additional amount recognised as a current period item (i.e., in the income statement). If, after initial recognition the provision required by IAS 37 is lower than the amount recognised at acquisition, the liability is recognised at the fair value on acquisition and decreased only for amortisation or upon settlement. In our view, accretion of any discount on a provision recognised for an acquired contingent liability is interest expense that should be recognised in the income statement. The accretion should not be recognised as an adjustment of the purchase price.

IAS 37.33 In our view, the recognition criteria of IAS 37 apply to acquired contingent assets. IAS 37 does not allow recognition as an asset until receipt is virtually certain.

Restructuring provisions#

IAS 22.31 (1998) A restructuring provision in relation to the acquiree is recognised as part of the purchase accounting if the main features of the restructuring are planned and announced by the date of acquisition; a detailed formal plan then is required within three months of the acquisition or by the date of authorisation of the financial statements (whichever is earlier).

IAS 37.70-83 The recognition of a restructuring provision under IAS 22 is an exception to the general recognition requirements for restructuring provisions in IAS 37 (see 3.11). This section discusses only those issues that relate to a business combination.

IAS 22.31 (1999) A restructuring provision does not include any costs associated with the restructuring of the acquirer's activities even though such restructuring may be caused by the acquisition. In addition, IAS 22 limits the types of activities that can be included in the restructuring to:

- terminating employment contracts;
- closing facilities;
- eliminating product lines; or
- terminating onerous contracts.

IAS 22.31 (1999), 37.80 This above list of activities is exhaustive and other costs should not be included in the restructuring provision.

Forthcoming requirements

IFRS 3.41 IFRS 3 limits restructuring liabilities recognised as part of the cost of an acquisition to those liabilities that, under the recognition criteria of IAS 37 would be recognised by the acquiree at the acquisition date (see 3.11). A restructuring plan that is conditional upon a future business combination is not, immediately before the business combination, a present obligation of the acquiree nor is it a contingent liability. Therefore, under IFRS 3, a provision for the acquiree's planned restructuring of the acquired business cannot be recognised as part of the business combination..

Impairment losses

IFRS 3.B 16(f), IAS 36.5 As noted above, the carrying amounts of assets acquired in a business combination are determined by reference to their fair value. There is no basis in IAS 22 for recognising an asset at a lower value in the event that the asset's recoverable amount is its net selling price and the estimated disposal costs are material (see 3.9)#. In the rare event that this did occur, our view is that any impairment loss should be recognised as a post-acquisition event.

For example, the fair value of an owner-occupied property is 800. The property was used by the acquiree, but will not be used after the business combination due to redundancies . The acquiree estimated that disposal costs (e.g., marketing, legal fees) would be approximately 50. The property

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should be recognised at its fair value of 800 in the purchase accounting. After the acquisition the acquirer should reassess the recoverable amount of the property based on its future plans and intentions, and should recognise a post-acquisition impairment loss of 50 (assuming that the net selling price of 750 is greater than the value in use).

Forthcoming requirements

IFRS 3.36 IFRS 5 amended IFRS 3 to require that assets acquired in a business combination that are classified as held for sale are recognised at fair value less costs to sell (see 5.4A). As a result, the property in the example above would be measured at 750 in the purchase accounting assuming it met the criteria to be classified as held for sale.

Fair value adjustments

Time period allowed#

IAS 22.71-76 (1998) In general, the period for identifying acquired assets and liabilities and adjusting their fair values against goodwill or negative goodwill must not go beyond the end of the first annual accounting period commencing after the acquisition. For example, an acquirer, which has a December balance sheet date, acquired a new subsidiary in March 2002. Fair value adjustments may not be made after 31 December 2003.

IAS 22.71, 75, 85 (1998) As exceptions to the above time limit:

- Any additional restructuring provision recognised cannot be increased against goodwill after the earlier of three months from the date of acquisition and the authorisation of the first financial statements following the acquisition; and any reversals of the restructuring provision always are adjusted against goodwill.
- Increases (but not decreases) to the deferred tax assets of the acquiree (but not of the acquirer) are adjusted against goodwill indefinitely.

IAS 22.71 (1998) Fair value adjustments should be recognised only to the extent that they do not increase the carrying amount of goodwill above its recoverable amount (see 3.9). In addition, adjustments made outside of the above time frame should be recognised in the income statement.

In our view, the above limit on recognising an additional restructuring provision relates to a new provision recognised subsequent to the date of acquisition, and not to a change in estimate for an existing restructuring provision that was recognised as part of the purchase accounting originally. We believe that any such changes in estimate should follow the general rule for fair value adjustments (i.e., any adjustments recorded as revisions to the purchase price should be made by the end of the first annual accounting period commencing after the acquisition).

For example, a restructuring provision of 100 was recognised as part of the purchase accounting. The provision comprised an amount of 80 for staff redundancies and 20 for terminating a lease agreement. Six months after the acquisition negotiations with the unions are completed and the final amount payable in respect of redundancies is 90. In our view, the change in estimate is recognised as a fair value adjustment.

IAS 22.93 (1998) If an entity can determine the fair values of an acquiree's identifiable assets and liabilities only on a provisional basis at the end of the period in which a business combination occurs, it should disclose that fact. However, such disclosure is not a condition that must be met in order to adjust those fair values, and there also is no requirement that the acquirer should have been actively seeking additional fair value information. For example, an acquirer completes its fair value exercise and accordingly does not disclose that those fair values are provisional. In the following period the acquirer discovers by chance that an additional asset should have been recognised separately from goodwill. The entity should make the fair value adjustment (subject to the considerations below).

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IAS 8.41, 22.71, 72 (1998)

IAS 22 contains no guidance on whether the above time limits apply even where errors are found in the purchase accounting. In our view, the guidance in IAS 8 applies to any errors that are discovered in respect of the purchase accounting (see 2.8) because the adjustments referred to in IAS 22 relate to the recognition criteria not being met and additional evidence becoming available. Such adjustments are different from errors, which relate to mistakes, oversight, misinterpretation and fraud.

Forthcoming requirements

IFRS 3.62

IFRS 3 limits the time period for adjusting the fair values assigned to assets, liabilities and contingent liabilities against goodwill to 12 months from the date of acquisition.

IFRS 3.63, 65

Adjustments to the fair value of assets, liabilities and contingent liabilities after the 12-month period are recognised only to correct errors (see 2.8), or to adjust deferred tax assets that could not be recognised separately at the date of acquisition.

When such a deferred tax asset is recognised, income is increased (see 3.12) and goodwill is reduced to the amount that would have been recognised if the deferred tax asset had been recognised at the date of acquisition. Any reduction in goodwill is recognised as an expense.

IAS 12.67

The acquirer may be able to recover its own deferred tax asset that was not recognised before the business combination, for example, against the future taxable profit of the acquiree. In such a case the acquirer recognises the deferred tax asset but does not include it as part of the accounting for the business combination. It is recognised through the income statement (see 3.12).

IFRS 3.62

The new standard does not allow recognition of assets or liabilities that meet the recognition criteria of IFRSs only after the date of acquisition. It allows estimation of provisional fair values for assets, liabilities and contingent liabilities at the date of acquisition and requires all assets, including intangibles assets, liabilities and contingent liabilities to be identified separately at the date of the acquisition.

Types of adjustments allowed#

IAS 22.72, 73 (1998), IFRS 3.36

In order for an adjustment to be made to the fair values determined originally, it must be demonstrated that the new evidence provides better evidence of the item's fair value at the date of acquisition. If an asset acquired in a business combination is impaired shortly after the acquisition date, this may be evidence that the value assigned in purchase accounting was overstated. The purchase price allocation (including goodwill) should be adjusted if the impairment is identified within the time period allowed, unless the loss relates to specific events or changes in circumstances occurring after the date of acquisition.

For example, at the date of acquisition the fair value of the acquiree's head office is estimated at 4,000. Two months after the acquisition the real estate market declines significantly due to an unexpected change in land-use laws and the value of the property falls to 2,500. The fall in value relates to a post-acquisition event and accordingly no adjustment to goodwill should be made. Instead, the property is assessed for impairment in accordance with IAS 36 and any resulting loss is recognised in the income statement (see 3.9).

IAS 22.72, (1998)

The new information may provide evidence of an asset or liability that existed at the date of acquisition, but which was not recognised, either because the recognition criteria were not met or because the acquirer was unaware of its existence. For example, at the date of acquisition the acquiree had a contingent asset (legal action) that was not included as part of the purchase accounting. Four months later the action is settled and the acquiree receives a settlement of 500. In our view, a fair value adjustment should be made because the settlement confirms that an asset existed at the date of acquisition.

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Forthcoming requirements

IFRS 3.62 The new standard does not allow recognition of assets or liabilities that meet the recognition criteria of IFRSs only after the date of acquisition. It allows estimation of provisional fair values for assets, liabilities and contingent liabilities at the date of acquisition and requires all assets, including intangibles assets, liabilities and contingent liabilities to be identified separately at the date of the acquisition.

IAS 38.45 (1998) In another example, at the date of acquisition the acquiree had development projects in progress that were not recognised because the acquiree had concluded that the criteria for capitalisation in IAS 38 were not met; in particular, it was not probable that the product would generate future economic benefits. At the time of the acquisition the acquirer agreed with this assessment and no asset was recognised as part of the purchase accounting. Two months later the acquirer completes its assessment of the future economic benefits and now is satisfied that the development project met the criteria for capitalisation *at* the date of acquisition#.

IAS 22.72 (1998), 38.59 (1998) In our view, it is preferable for the acquirer to recognise the asset as a fair value adjustment on the basis that IAS 22 refers explicitly to identifiable assets and liabilities that did not appear to meet the recognition criteria at the date of acquisition, but which subsequently are determined to have done so. Another approach would be not to recognise any asset on the basis that IAS 38 is explicit that amounts expensed previously should not be recognised as part of the cost of an intangible at a later date. In any event an entity should be consistent in its approach to these items in all acquisitions. In contrast, if the criteria for capitalisation were met only because of circumstances that arose after the date of acquisition, goodwill could not be adjusted.

Forthcoming requirements

IFRS 3.45 IFRS 3 requires an in-process research or development (IPR&D) project that meets the definition of an intangible asset (which normally is the case) and for which fair value can be measured reliably, to be recognised separately from goodwill. Subsequent to acquisition, this intangible asset is measured under the revised IAS 38 (see 3.3).

Adjusting goodwill

SIC 22 (1999), IFRS 3.62(b), 3.IE If the fair values of identifiable assets or liabilities are adjusted, goodwill or negative goodwill is adjusted with effect from the date of acquisition, but with the cumulative effect of the adjustment recognised in the current period income statement.

IFRS 3.65 When deferred tax assets of the acquiree are realised in excess of the amount recognised at the date of acquisition as part of the purchase accounting:

- the additional tax benefit is recognised in the income statement in the tax line; and
- goodwill is adjusted to the amount that would have been recognised if the tax benefit had been recognised as part of the purchase accounting, and the adjustment (net of subsequent amortisation) also is recognised in the income statement.

For example, C acquired D on 1 July 2002 giving rise to goodwill of 100, which is being amortised# over 10 years; as part of the purchase accounting a deferred tax asset relating to D of 20 was recognised. At 31 December 2004, C concludes that a deferred tax asset of 40 should have been recognised in respect of D. If a deferred tax asset of 40 had been recognised, goodwill would have been reduced to 80. Over the period to 31 December 2004 this would have decreased the amortisation of goodwill by five (20/120 months x 30 months); the net adjustment to goodwill is 15 (20 - 5).

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Therefore, the following journal entries are required:

	Debit	*Credit*
Deferred tax asset	20	
Income statement (income taxes)		20
Income statement (operating expenses)	15	
Goodwill		15

Forthcoming requirements

IFRS 3.51-55

IFRS 3 requires goodwill to be recorded at cost less accumulated impairment losses after initial recognition. Goodwill is not amortised, as required previously under IAS 22, but instead is subject to impairment testing at least annually.

Goodwill

IAS 22.41-45, 99 (1998)

The accounting for goodwill is discussed in 3.3. However, in summary goodwill arising in financial statements covering periods beginning on or after 1 January 1995 must be capitalised and amortised over its estimated useful life, which generally does not exceed 20 years#.

Forthcoming requirements

IFRS 3.51-55

IFRS 3 requires goodwill to be recorded at cost less accumulated impairment losses after initial recognition. Goodwill is not amortised, as previously required under IAS 22, but instead is subject to impairment testing at least annually.

Negative goodwill#

IAS 22.61-64 (1998)

Unamortised negative goodwill is presented as a deduction from the asset category containing goodwill – effectively as a negative asset. It is credited to the income statement as follows:

- first, to the extent that it relates to post-acquisition losses and expenses that are identified in the acquirer's plans for the acquisition and can be measured reliably, at the same time as those losses and expenses are recognised;
- the balance, up to the amount of the fair value of the non-monetary assets acquired, over the useful life of the acquired depreciable / amortisable non-monetary assets; and
- any remaining balance, immediately.

IAS 22.61 (1998)

Although IAS 22 does not place a time limit on the losses and expenses to which negative goodwill should be matched, the losses and expenses must have been identified in the acquirer's acquisition plan. The acquirer cannot decide subsequently to match the negative goodwill against unexpected losses and expenses that arise.

If the identified losses and expenses exceed the amount of negative goodwill recognised, in our view, it would be preferable to recognise the negative goodwill on a *pro rata* basis over the period, rather than matching the negative goodwill exactly until it is exhausted. For example, losses of 500, 200 and 100 are expected over three years, and negative goodwill is 600. We believe it would be preferable to recognise 375 of the negative goodwill in year one (600/800 x 500), 150 in year two and 75 in year three.

IAS 22.62 (1998)

After matching negative goodwill to expected losses and expenses, the next step is to set aside an amount of negative goodwill up to the value of the non-monetary assets acquired. For example, the remaining balance of negative goodwill is 150, and the non-monetary assets comprise plant (130) and inventory (70). In this case, the entire amount of negative goodwill is matched to the non-monetary assets.

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IAS 22.62 (1998)

However, despite matching negative goodwill against all non-monetary assets, it is amortised over the useful life of only the depreciable / amortisable non-monetary assets. Continuing the above example, the entire negative goodwill would be recognised in the income statement over the useful life of the plant; the calculation of weighted average life would not reflect the expected realisation of non-depreciable non-monetary assets (e.g., inventory).

IAS 22.68 (1998)

There are no special rules for the treatment of negative goodwill in the event that there is unrecognised contingent consideration. This means that if negative goodwill subsequently becomes positive goodwill once the contingent consideration is recognised, any entries recorded in accordance with the requirements for negative goodwill will need to be reversed. In this case, the adjustment would be recognised in the same period that the contingent consideration is recognised; comparatives should not be restated.

IAS 22.64 (1998)

Positive and negative goodwill are accounted for separately. While they are presented in the same balance sheet classification, negative goodwill cannot be allocated to write-off positive goodwill.

Forthcoming requirements

IFRS 3.56, 57

IFRS 3 no longer includes the concept of negative goodwill. If there is an excess of the acquirer's interest in the net fair values of the identifiable assets, liabilities and contingent liabilities acquired over the costs paid, the acquirer must:

- reassess the identification and measurement of identifiable assets, liabilities and contingent liabilities; and
- recognise any remaining excess in profit or loss immediately on acquisition.

Push down accounting

"Push down" accounting, whereby fair value adjustments recognised in the consolidated financial statements are "pushed down" into the financial statements of the subsidiary is not addressed by, and has not been used under IFRSs. However, some fair value adjustments could be reflected in the acquiree as revaluations if permitted by the relevant standards (as long as the revaluations are kept up to date subsequently), or as accounting policy changes (provided it results in a more appropriate presentation – see 2.8).

IAS 16.31-42, 38.78

For example, E acquires all of the shares in F and as part of the purchase accounting recognises land and buildings at 500 (the previous cost-based carrying amount was 300) and a trademark at 150 (not recognised previously). In our view, F could recognise the fair value adjustment of 200 in respect of land and buildings in its own financial statements if it changed its accounting policy to one of revaluation and complied with all the requirements of IAS 16, including the need to keep revaluations up to date (see 3.2). However, we believe that F could not revalue the trademark in its own financial statements since this is prohibited by IAS 38.

2.6.4 Business combination achieved in stages

IAS 22.36-38 (1998)

When a business combination is achieved in successive share purchases (a "step acquisition"), each significant transaction is accounted for separately and the identifiable assets and liabilities acquired are stated at fair value. As with a single acquisition, the portion attributable to minority interests may be based on either the acquiree's book values or fair values (see 2.6.3)#.

Forthcoming requirements

IFRS 3.40

IFRS 3 removes the option to measure minority interest at the book value of the minority's share of the assets acquired and liabilities assumed. Instead, it requires minority interest to be measured at the minority's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities.

For example, P acquires a 10 per cent interest in S and an additional 60 per cent some years later. Assuming that P did not have significant influence over S, the business combination requirements of

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IFRSs will apply only at the date that the additional 60 per cent is acquired since this is when control is obtained. Prior to the acquisition of the additional 60 per cent, the 10 per cent interest would be accounted for in accordance with IAS 39 (see 3.6).

IAS 22.37 (1999)

In addition, IAS 22 permits (but does not require) the share of the identifiable assets and liabilities acquired in previous transactions to be revalued. Since the standard is explicit in allowing such revaluations, in our view, any such revaluation does not require an entity to adopt an ongoing policy of revaluation for qualifying assets#. For example, we believe that the acquiree's property, plant and equipment could be revalued on a one-off basis to the extent of the acquirer's previously held interest without revaluing all other property, plant and equipment of the group that are in the same class in accordance with IAS 16 (see 3.2).

Forthcoming requirements

IFRS 3.59

IFRS 3 reinforces this position by stating that any adjustment to fair values of the identifiable assets and liabilities acquired in previous transactions is a revaluation. However, IFRS 3 notes that this fair value adjustment does not require the acquirer to apply a policy of revaluing those items after initial recognition in accordance with, for example, IAS 16.

Worked example

IAS 22.32-38 (1999)

The following example illustrates the step acquisition. The example is based on the allowed alternative treatment in paragraph 34 of IAS 22 of measuring minority interest and all acquired net assets at fair value (which is the required treatment under IFRS 3).

L acquired 20 per cent of M for 300 on 1 January 2001.

L acquired an additional 40 per cent of M for 600 on 1 January 2003.

Financial position of M

	1 January 2001		*1 January 2003*	
Equity	800		1,000	
Fair value of assets over book value	100		150	
Fair value of net assets	900		1,150	
Fair value of portion acquired	180	900 x 20%	460	1,150 x 40%
Consideration	300		600	
Goodwill	120		140	

In this example, it is assumed that the 20 per cent interest has been accounted for as an equity accounted associate in accordance with IAS 28. If significant influence did not exist, the investment would be a financial asset that is measured in accordance with IAS 39.

In this case:

- the acquired identifiable assets and liabilities assumed are recognised at their fair value at the acquisition date (which is the date at which control passes to the acquirer);
- minority interests are measured using the acquiree's fair values at the date of acquisition (i.e., a portion of the 150 excess of the fair value over book value of net assets is recognised in respect of minority interests); and
- previously acquired interests are revalued when the additional 40 per cent interest is acquired (i.e., a portion of the increase of 50 in the fair value of net assets since L acquired a 20 per cent interest is recognised).

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Consolidated financial position of L

1 January 2003	*L*	*M*	*Consolidation entries*	*Consolidated*
Investment in subsidiary	900	-	(900)	-
Goodwill	-	-	260	260
Other net assets	5,000	1,000	150	6,150
Net assets	5,900	1,000	(490)	6,410
Revaluation reserve	-	-	10	10
Other equity components	5,900	1,000	(960)	5,940
Minority interests	-	-	460	460
	5,900	1,000	(490)	6,410

The consolidation entries comprise the following (see calculations below):

	Debit	*Credit*
Equity	960	
Other net assets	150	
Goodwill	260	
Minority interests		460
Revaluation reserve		10
Investment		900

The debit to equity of 960 is the 1,000 equity of M at the date of acquisition less an amount of 40, which represents the increase in equity attributable to L while it held the 20 per cent interest (1,000 - 800 x 20 per cent).

The credit to minority interests is the minority share of the fair values of M's assets and liabilities (i.e., 1,150 x 40 per cent).

The credit to investment is the sum of the consideration paid (300 + 600).

The revaluation reserve is the increase in the fair value of M's net assets from L's previously acquired interest (i.e., 150 - 100 x 20 per cent).

Further acquisition after control is obtained

Although IAS 22 is not explicit, we believe that the requirements for successive share purchases apply by analogy (except for necessary modifications) when an acquirer acquires an additional interest in a subsidiary after obtaining control#. If, for example, L acquires an additional 10 per cent interest in M for 200 on 1 January 2004; we believe that the above requirements could be applied to the acquisition of the additional 10 per cent interest. Assuming that L in its consolidated financial statements has recognised net assets of M at 1,300 (with a fair value on 1 January 2004 of 1,500), L would recognise additional goodwill of 50 (200 - (1,500 x 10 per cent)) and remeasure the net assets related to the additional interest acquired at fair value (i.e., recognise a revaluation adjustment of 20 ((1,500 - 1,300) x 10 per cent)).

Forthcoming requirements

IFRS 3.BC157 IFRS 3 also is not explicit regarding the requirements for successive share purchases. In the basis for conclusion, the Board notes that it has not revised the requirements of IAS 22 relating to step acquisition.

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IAS 27.33

However, revised IAS 27 requires minority interest to be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. The presentation of minority interest within equity supports the recognition of increases and decreases in ownership interests in subsidiaries without loss of control as equity transactions in the consolidated financial statements. Accordingly, any premiums or discounts on subsequent purchases of equity instruments from (or sales of equity instruments to) minority interests would be recognised directly in the parent shareholders' equity. In our view, because the issue is not explicitly addressed in IFRSs, the above guidance under *Further acquisition after control is obtained* still is applicable. Alternatively, an entity that applies the revised IAS 27 could recognise directly in equity increases (or decreases) in the parent shareholders' interest, while the parent controls the subsidiary.

Obtaining fair value information

In many cases when previously acquired interests did not constitute an associate or joint venture (see 3.5), it will be difficult to obtain fair value information in respect of the acquiree's identifiable assets and liabilities at the date of the previous acquisitions. However, the requirements for successive share purchases are based on the assumption that such fair value information can be obtained.

For example, P acquired a 10 per cent interest in S in 1998. In March 2003, P acquired an additional 70 per cent interest in S. Even though the 10 per cent investment is accounted for at fair value in accordance with IAS 39, P has no information about the fair value of S's identifiable assets and liabilities in 1998.

In our view, in this example, it would be acceptable to assume that the goodwill attributable to the first acquisition is the difference between the amount paid for the 10 per cent interest and the book values of S's net assets at that date. Another alternative would be to compare the total cost of both acquisitions (the 10 per cent plus the 70 per cent) to the fair values of S's net assets at the date of the second acquisition; however, this is not our preferred method because different acquisitions are combined as if they were one. In determining an appropriate shortcut method for measuring goodwill, the materiality of the transactions also should be considered.

2.6.5 Uniting of interests accounting#

The identification of a uniting of interests is discussed above under 2.6.2.

Forthcoming requirements

IFRS 3.14

Under IFRS 3 all business combinations must be accounted for using the purchase method. The uniting of interests method cannot be used for transactions within the scope of IFRS 3.

IAS 22.77-79 (1998)

Since a uniting of interests does not involve an acquisition but rather is a continuation of the businesses that existed before, the financial statements of the combining entities are added together (i.e., using book values) for the current and all prior periods. In the process of combination uniform accounting policies are adopted.

For example, G and H combine in a uniting of interests, with G being the continuing entity. G issues 300 shares and pays a small amount of cash (5) to obtain the entire issued capital of H. The table below shows G immediately before the transaction, the consideration given to become the parent of H, and the aggregation and adjustment to achieve the consolidated financial statements.

IAS 22 does not specify the amount that should be recorded as the share capital issued in a uniting of interests; in this example it would be the amount to be recorded in respect of the 300 shares issued by G. This is consistent with the overall approach under IFRSs of not specifying how an entity's capital accounts should be dealt with (see 3.10). In practice, generally the amount recorded is determined by reference to local company law or regulatory requirements. In this example the shares are recorded at their par value.

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	G prior	*Invest in H*	*G after*	*H*	*Adjust*	*G combined*
Current assets	900	(5)	895	1,000	-	1,895
Non-current assets	1,500	305	1,805	1,800	(305)	3,300
Current liabilities	(500)	-	(500)	(600)	-	1,100
Non-current liabilities	(800)	-	(800)	(900)	-	(1,700)
Net assets	1,100	300	1,400	1,300	(305)	2,395
Retained earnings	800	-	800	1,100	-	1,900
Issued capital	300	300	600	200	(200)	600
Difference	-	-	-	-	(105)	(105)
	1,100	300	1,400	1,300	(305)	2,395

IAS 22.79 (1998)

The "difference" of 105 represents the difference between the amount recorded as share capital issued plus any additional consideration paid for H's shares (305) and the amount recorded as the share capital acquired (200). IAS 22 requires the difference to be adjusted against equity, but does not specify the exact presentation. In our experience it is common for the amount to be placed in a separate reserve and named "merger reserve".

2.6.6 Common control transactions

IAS 22.7 (1998)

As noted above (under 2.6.1), the accounting for transactions among entities under common control is specifically excluded from the scope of the business combinations standard. In addition, common control is not a defined term#. In our view, common control means that two entities are controlled by the same shareholder, or by a group of shareholders sharing control.

Forthcoming requirements

IFRS 3.A

IFRS 3 defines a business combination involving entities or businesses under common control as "a business combination in which all of the combining entities or businesses ultimately are controlled by the same party or parties both before and after the combination, and that control is not transitory".

IFRS 3.11-13

IFRS 3 further clarifies that a group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. It is not necessary that an individual or a group of individuals acting together under a contractual arrangement to control an entity are subject to the financial reporting requirements of IFRSs. Therefore, in order to meet the definition of business combinations involving entities under common control, the combining entities are not required to be part of the same consolidated financial statements. Further, the extent of minority interests in each of the combining entities before and after the business combination is not relevant to determine whether the combination involves entities under common control. However, transactions that impact the level of minority interest are discussed in 2.6.4 and under *Minority interests* below.

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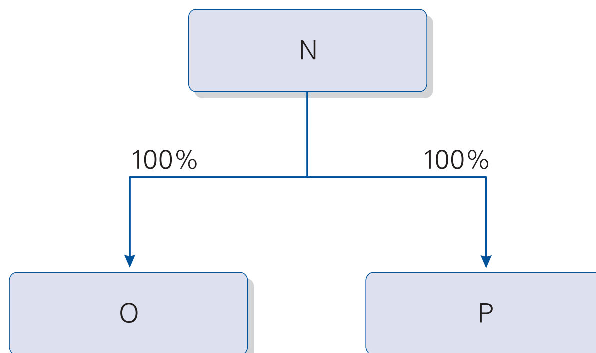
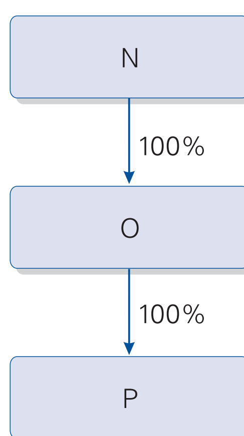
No minority interests

In the following structure O and P are under the common control of N.



If N decides to restructure the group so that O holds all of the shares in P, this is referred to as a common control transaction.



The above transaction has no impact on the consolidated financial statements of N since the entity continues to have a 100 per cent interest in both O and P. From N's perspective this is an inter-entity transaction. It is not a business combination because N does not obtain control. It is therefore not, from N's perspective, a common control transaction. However, an issue arises in O's financial statements as to whether it should record the "acquisition" of P using fair values or book values. In our view, O may make an accounting policy election, which should be applied consistently to all common control transactions, either:

- to recognise the transaction using book values on the basis that the transaction has no economic substance and the investment in P is simply being moved from one part of the group to another; or
- to recognise the transaction using fair values on the basis that O is a separate entity in its own right with its own personality, and should not be confused with the economic group as a whole.

The use of fair values may be appropriate where the transaction has economic substance, in particular when the purchase price is determined on an arm's length basis.

A further issue that arises when using book values is whether the book values should be those of P in its own financial statements, or the book values of P as they appear in N's consolidated financial statements (i.e., including goodwill and any fair value adjustments).

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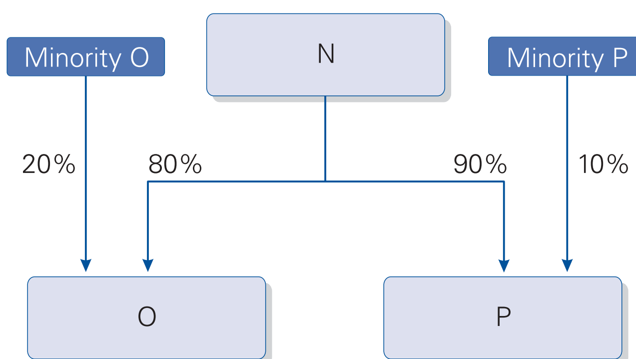
In our view, O may make an accounting policy election, which should be applied consistently to all common control transactions, either:

- to use consolidated book values on the basis that the investment in P is simply being moved from one part of the group to another so the carrying amounts in the consolidated financial statements should be preserved; or
- to use the book values in P on the basis that using the consolidated book values might be seen as something similar to "push down" accounting whereby consolidation adjustments are recorded in the financial statements of a subsidiary, which generally is not permitted under IFRSs (see 2.6.3).

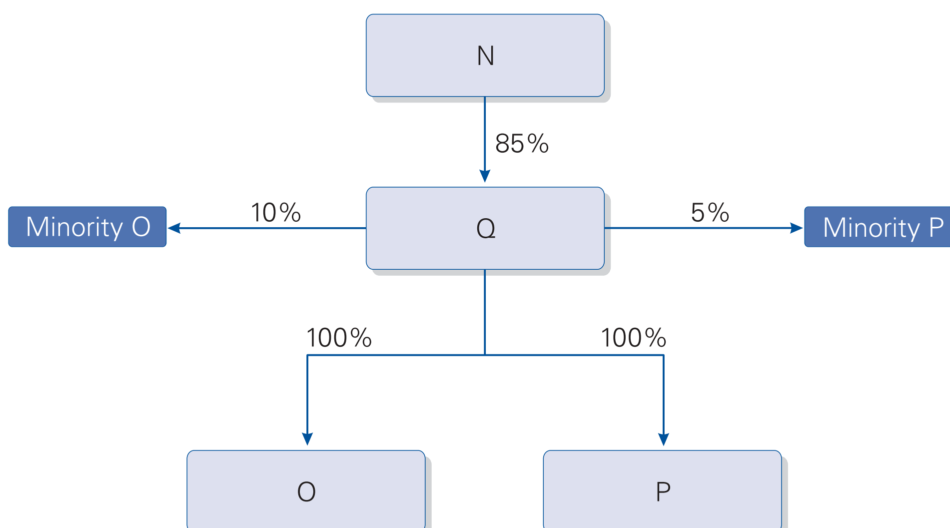
Minority interests involved

In our view, the presence of minority interests is not relevant to the concept of common control. For example, O and P are under the common control of N despite the minority interests in both entities.



In our view, it is preferable for a common control transaction to be accounted for using fair values to the extent that minority interests are acquired. This is similar to the accounting for successive share purchases (see 2.6.4) whereby additional acquisitions are accounted for at fair value.

Continuing the above example, N decides to restructure its group by inserting a new entity Q, which will hold all of the shares in O and P. In return, the minority interests obtain shares in Q.



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In our view, it is preferable for this transaction to be accounted for as follows in the financial statements of Q:

- Q should use purchase accounting (i.e., fair values) to recognise the acquisition of the 20 per cent minority interest in O and the 10 per cent minority interest in P.
- The remaining interests in O and P (80 per cent and 90 per cent respectively) should be recognised using book values. As discussed above, the book values may be either those presented in N's consolidated financial statements or those of the subsidiaries themselves.

Notwithstanding our view of the most appropriate accounting, the absence of specific guidance on accounting for common control transactions has led to divergence in practice, including the complete use of book values or the complete use of fair values to account for transactions such as this. Whatever method of accounting is adopted, the entity should make an accounting policy election that should be applied consistently to all common control transactions.

2.6.7 Reverse acquisitions

IAS 22.12 (1998)

While guidance is provided for identifying a reverse acquisition (see 2.6.3), IAS 22 provides no accounting guidance#. In practice reference often is made to the Canadian guidance on this topic since it is a comprehensive guide and, in our view, consistent with the Framework (see 1.2). Accordingly, the guidance that follows is based on EIC–10 *Reverse Takeover Accounting* issued by the Emerging Issues Committee of the Canadian Institute of Chartered Accountants.

Forthcoming requirements

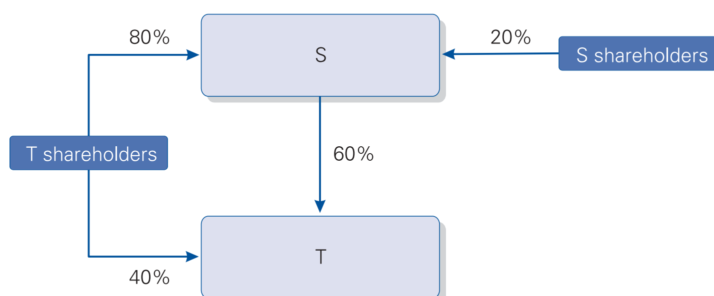
IFRS 3.21

IFRS 3 now provides guidance on accounting for reverse acquisitions consistent with the approach explained below.

IFRS 3.B7-9

In a reverse acquisition the legal subsidiary becomes the acquirer for accounting purposes, and the legal parent becomes the subsidiary for accounting purposes. Therefore, it is the identifiable assets and liabilities of the legal parent that are measured at fair value.

For example, S acquires 60 per cent of the shares in T. As consideration S issues its own shares to T's shareholders; however, S issues so many shares that T's shareholders obtain an 80 per cent interest in S. After analysing all of the elements of control (see 2.5), it is concluded that T is the acquirer for accounting purposes. Therefore, S is the legal parent and accounting subsidiary, and T is the legal subsidiary and accounting parent.



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The accounting for a reverse acquisition is illustrated by continuing the example of S and T.

Financial position prior to the acquisition

	S	T
Current assets	1,000	1,500
Non-current assets	2,000	2,500
Current liabilities	(300)	(600)
Non-current liabilities	(1,500)	(800)
Net assets	1,200	2,600
Retained earnings	1,100	2,500
Share capital of S (100 shares)	100	-
Share capital of T (100 shares)	-	100
Equity	1,200	2,600

Additional information

S acquires 60 per cent of the shares in T, and issues 400 shares in itself as consideration.

At the date of acquisition the fair value of each share of S is 4 and the fair value of each share of T is 100.

The fair value of S's property, plant and equipment is 200 more than its book value. There are no other fair value adjustments.

Step 1 – calculate the cost of acquisition

From a legal point of view S's shareholders have obtained a 60 per cent interest in T. However, from an accounting point of view T's shareholders have obtained an 80 per cent interest in S; the remaining 20 per cent interest is held by S's shareholders.

Since T is the accounting acquirer, we need to calculate how many shares it would have issued in order to give the T shareholders an 80 per cent interest in S. In calculating the number of shares that would have been issued, the minority interest is ignored. (This is a hypothetical calculation because T never issued any shares since it is the legal subsidiary.)

The majority shareholders own 60 shares in T. For this to represent 80 per cent, T would have to issue 15 shares.

So the cost of acquisition is determined as the number of shares that T would have issued (15) multiplied by the fair value of its shares (100). Therefore, the cost of acquisition is 1,500.

Step 2 – calculate goodwill

The goodwill is calculated by comparing the cost of acquisition (incurred theoretically by T) to the fair value of the net assets acquired (of S).

Net assets	1,200
Fair value adjustment	200
Total fair value	1,400
Cost of acquisition	1,500
Goodwill	100

The goodwill calculation in a reverse acquisition always assumes that the accounting acquirer (T) acquires 100 per cent of the accounting subsidiary (S). This is because the consolidated financial statements are legally those of the legal parent (explained below), which is S, and legally the

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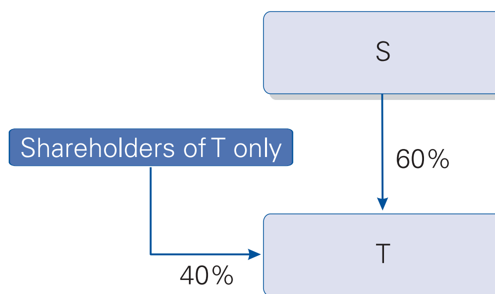
minority interests in that group are the T shareholders (i.e., the 40 per cent). Accordingly, there are no minority interests in S. Therefore, the calculation of goodwill is based on a 100 per cent interest in S.



Step 3 – calculate minority interests

IFRS 3.B10, 11

As noted in step 2, the minority interest in the transaction is represented by those non-participating shareholders who decided not to exchange their shares for shares in S; in this example it is the 40 per cent held by the T shareholders. These shareholders have an interest in the net assets of T.

Net assets of T	2,600
Minority interest	40%
Minority interests in the balance sheet	1,040

The minority interests' share of net assets must be calculated using book values because T is the accounting parent and therefore its assets cannot be remeasured to fair value.

Financial position after the acquisition

	S	*T*	*Combined*	*Adjust (see below)*	*S consol*
Current assets	1,000	1,500	2,500		2,500
Goodwill	-	-	-	100	100
Other non-current assets	2,000	2,500	4,500	200	4,700
Current liabilities	(300)	(600)	(900)		(900)
Non-current liabilities	(1,500)	(800)	(2,300)		(2,300)
Net assets	1,200	2,600	3,800	300	4,100
Retained earnings	1,100	2,500	3,600	(2,100)	1,500
Share capital	100	100	200	1,360	1,560
Minority interests	-	-	-	1,040	1,040
	1,200	2,600	3,800	300	4,100

The adjustments comprise the following journal entries:

	Debit	*Credit*
Retained earnings of S	1,100	
Share capital of S	100	
Property, plant and equipment	200	
Goodwill	100	
Share capital (cost of acquisition)		1,500
Retained earnings of T	1,000	
Share capital of T	40	
Minority interests		1,040

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The consolidated financial statements should be issued in the name of the legal parent (S), but the financial information included in the consolidated financial statements until the date of acquisition, including the comparatives, should be that of the legal subsidiary (T). However, because legally the financial statements are those of the legal parent (S), the number of shares is the number of shares issued by the legal parent (100 plus 400 in this example). In addition, any split between share capital and share premium will be determined by reference to the par value of the shares of the legal parent (S).

IFRS 3.21, 3.B

In practice the presentation of consolidated financial statements following a reverse acquisition can be confusing for readers, and often the legal parent changes its name to be similar to that of the accounting parent. The financial statements should include full disclosure of the reverse acquisition, in addition to the general disclosure requirements of both the business combinations and cash flow standards.

2.6.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The IASB's ongoing business combinations project may have a significant impact on the requirements of IFRSs in this area.

Proposals for a limited amendment to IFRS 3

On 29 April 2004, the IASB published for public comment proposals for a limited amendment to IFRS 3. The proposals are set out in the exposure draft *Combinations by Contract Alone or Involving Mutual Entities*. The main feature of the exposure draft is to remove IFRS 3's scope exclusion for combinations involving two or more mutual entities or combinations in which separate entities are brought together to form a reporting entity by contract alone without obtaining an ownership interest. This includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

Business combinations phase II

The information that follows is based on the discussions of the IASB. An exposure draft is expected to be published in the fourth quarter of 2004.

Fair value of assets and liabilities acquired

Contingent assets would be measured at fair value as part of the purchase accounting, and would continue to be measured at fair value subsequent to the acquisition.

Goodwill and negative goodwill

The full amount of goodwill would be recognised, including that portion attributable to minority interests.

Working principle: application of purchase method

In a business combination the total amount to be recognised by the acquirer would be the fair value of the net assets over which it obtains control. Assuming an exchange of equal values, there is a rebuttable presumption that the consideration paid by the acquirer provides the best basis for measuring the fair values of those net assets.

Issues relating to minority interests

Minority interests to share a portion of goodwill and purchase of minority interests should be treated as the purchase of equity.

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Business combination achieved in stages

When the acquirer obtains control of an acquiree in a step acquisition, the carrying amount of any previous investment in the acquiree would be remeasured to fair value at the date of acquisition. The resulting gain or loss would be recognised in the consolidated income statement.

Issues relating to measurement of consideration

In the interests of convergence with US GAAP, the IASB has agreed that the date of acquisition would remain the measurement date for equity instruments issued as consideration.

Issues relating to the recognition and measurement of the identifiable net assets acquired

The IASB would provide additional guidance for measuring fair value in the form of a hierarchy to ensure the consistent application of the fair value working principle. The following are other areas in which the Board would provide guidance:

- the role of credit risk in determining the fair value of a liability;
- measurement of post-employment benefit obligations assumed in a business combination; and
- recognition and measurement of deferred tax assets.

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2.7 Foreign exchange translation

(IAS 21, IAS 29, SIC–11, SIC–19, SIC–30)

Overview

- **An entity measures its assets, liabilities, revenues and expenses in its functional (measurement) currency, which is the currency that best reflects the economic substance of the underlying events and circumstances relevant to the entity.**
- **An entity may present its financial statements in a currency other than its functional (measurement) currency.**
- **All transactions that are not denominated in an entity's functional (measurement) currency are foreign currency transactions; exchange differences arising on translation generally are recognised in the income statement.**
- **Foreign operations are classified as either integrated (if their activities are an integral part of the parent's) or otherwise as foreign entities#.**
- **The financial statements of integrated foreign operations are translated into the entity's functional (measurement) currency using the same method that is used to translate foreign currency transactions.**
- **The financial statements of foreign entities are translated into the entity's functional (measurement) currency using the foreign entity method; assets and liabilities are translated at the closing rate; revenues and expenses are translated at actual rates or appropriate averages#.**
- **If the functional (measurement) currency of a foreign entity is hyperinflationary, current purchasing power adjustments are made to its financial statements prior to translation; the financial statements, including comparatives, then are translated at the closing rate at the end of the current period#.**
- **When an investment in a foreign entity is disposed of, the exchange differences previously recognised directly in equity are transferred to the income statement.**
- **When financial statements are translated into a presentation currency other than the functional (measurement) currency, equity (excluding the current year's profit or loss) is retranslated at the closing rate at each balance sheet date#.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 21 *The Effects of Changes in Foreign Exchange Rate*. The revised standard incorporated the requirements of SIC–19 *Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29* and SIC–30 *Reporting Currency – Translation from Measurement Currency to Presentation Currency*, made consequential amendments to IAS 29 *Financial Reporting in Hyperinflationary Economies* and withdrew SIC–11 *Foreign Exchange – Capitalisation of Losses Resulting from Severe Currency Devaluations*. It is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text.

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In particular, the revised standard:

- specifies that each entity within a group has its own functional currency. On consolidation, the financial statements of each entity are *presented* in a common currency. This may be the functional currency of the reporting entity, but there is no concept of a *group* functional currency;
- requires translation of the comparative figures of the financial statement of a foreign entity whose functional currency is hyperinflationary by using the exchange rate at the comparative reporting date if the presentation currency is not hyperinflationary; and
- does not specify the method of translation of equity (excluding the current year's profit or loss), which should be consistent with the method of translation for a foreign entity.

2.7.1 Definitions

Functional (measurement) currency#

Forthcoming requirements

IAS 21 In the revised standard the term "functional currency" replaces "measurement currency". The two have similar meanings. However, the revised standard has added guidance for determining what the functional currency is. This revised guidance places significant emphasis on the currency of the cash flows to which the entity is exposed. The term "functional currency" is used in this section.

Choosing a functional currency

IAS 27.8 An entity measures its assets, liabilities, equity, revenues and expenses in its functional currency, which is the currency that best reflects the economic substance of the underlying events and circumstances relevant to the entity. All transactions in currencies other than the functional currency are foreign currency transactions (see below).

Generally, each entity in a group has its own functional currency. There is no concept of a group-wide functional currency under IFRSs. This is explained in more detail below under 2.7.4.

IAS 21.9, 10 The following factors#, which are not exhaustive, should be considered in determining an appropriate functional currency:

- the currency in which sales prices are denominated and settled, including consideration of the factors that influence the setting of sales prices;
- the currency in which labour, materials and other costs are denominated and settled;
- the currency in which purchases are financed; and
- the currency in which receipts from operating activities usually are retained (or converted to by choice or otherwise).

The above factors are provided in the form of an example where *all* the factors indicate the same functional currency. However, in our view, this should not be interpreted as meaning that *all* of these factors must indicate a certain currency in order for that currency to be the entity's functional currency. Often in practice entities operate in a mixture of currencies and judgement should be used in determining the most appropriate functional currency.

Forthcoming requirements

IAS 21.11, 12 The revised IAS 21 provides additional guidance on the determination of functional currency in the case of a foreign operation which is discussed in 2.7.4. The revised standard also places greater emphasis on the currency that determines the pricing of transactions than on the currency in which transactions are denominated. An entity may conclude that its functional currency is not that which it had concluded under previous versions of the standard.

In our view, an entity should start with a presumption that the local currency is its functional currency, and then consider whether there is persuasive evidence to justify using a different functional currency.

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For example, an entity in Russia produces goods that are exported throughout Europe. Sales prices are denominated in euro and some of the entity's cash reserves are held in euro; however, all of the other factors indicate that the rouble is the entity's functional currency. In our view, the functional currency is the rouble because there is not enough evidence to indicate that the euro overcomes the presumption that the rouble *best* reflects the economic substance of the underlying events and circumstances relevant to the entity.

As another example, an entity in the Philippines manufactures sports clothing that is exported to the United States. Sales prices are established having regard to prices in the United States, and are denominated in US dollars. Sales are settled in US dollars and the receipts are converted to Philippine pesos only when necessary to settle local expenses. The majority of the entity's borrowings are denominated in US dollars; and the cost of the manufacturing equipment, which is the entity's major item of property, plant and equipment, was denominated in US dollars. Management's salaries, which represent the significant portion of labour costs, are denominated and paid in US dollars; other labour costs, as well as all material costs, are denominated and settled in Philippine pesos. In our view, the entity's functional currency is the US dollar in this case.

In some cases an analysis of the underlying events and circumstances relevant to an entity may indicate that two (or more) currencies may be equally relevant. For example, a Turkish entity has analysed its operations as follows:

- the majority of short- and long-term debt is financed in US dollars; the balance is financed in Turkish lira;
- the activities of the entity are financed mainly by own capital (denominated in Turkish lira) and currencies other than US dollars;
- the majority of cash reserves are held in US dollars;
- export sales make up approximately 95 per cent of total sales, which are denominated largely in US dollars; and
- the majority of operating expenses is denominated in Turkish lira; the balance is denominated in US dollars.

Notwithstanding a starting presumption that Turkish lira is the appropriate functional currency, in our view, both the Turkish lira and the US dollar are key to the entity's operations, and it could be argued that either Turkish lira or the US dollar is the entity's functional currency#.

Forthcoming requirements

IAS 21.9, 12 When the indicators are mixed and the functional currency is not obvious, the revised IAS 21 stresses that management should give priority to indicators on its primary economic environment (e.g., the currency that mainly influences sales prices for goods and services, the country whose competitive forces and regulations mainly determine the sales prices of its goods and services and the currency that mainly influences labour, material and other costs of providing goods or services).

Changing the functional currency

IAS 21.13 Once an entity has selected its functional currency, that selection should not be changed unless there is a change in the underlying events and circumstances relevant to it. In our view, this is the case even if more than one functional currency is relevant to the entity, as in the Turkish lira / US dollars example above. If circumstances change and a change in functional currency is appropriate, the change should be accounted for prospectively. However, a prospective change triggers an issue with respect to the comparative financial information.

For example, an entity incorporated in the United Kingdom with a 31 December balance sheet date had the euro as its functional currency until the end of 2003. From the beginning of 2004 the focus of the entity's operations changes and the appropriate functional currency is determined to be sterling

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going forward. In our view, the financial statements, including comparatives for 2003, should be prepared as follows:

- at 1 January 2004 the financial position should be translated from euro into sterling using the exchange rate at that date. From 2004 the financial statements will be prepared with any non-sterling transactions translated following the requirements for foreign currency transactions (see 2.7.2); and
- the 2003 comparatives should be translated from euro, which is the functional currency for that period, into sterling using the procedures that apply for translation into a different presentation currency (see 2.7.6).

In our view, these procedures would apply equally when the legal currency of a country is changed. For example, on 1 January 2001 the legal currency in El Salvador changed from colones to US dollars.

Presentation currency

IAS 21.8, 38 Although an entity measures items in its financial statements in its functional currency, it may decide to present its financial statements in a currency other than its functional currency. For example, an entity with a euro functional currency may choose to present its financial statements in US dollars because its primary listing is in the United States.

When an entity presents its financial statements in a presentation currency that is not its functional currency, there is no requirement for it to present additional financial information in its functional currency.

2.7.2 Summary of approach to foreign currency translation

The following is a summary of the approach under IFRSs to foreign currency translation, which is explained in more detail in 2.7.3 to 2.7.6:

- All its own transactions that are not denominated in an entity's functional currency are foreign currency transactions. First these transactions are translated into the entity's functional currency.
- Next an entity analyses each of its foreign operations to determine whether those operations are integral to those of the entity (integrated foreign operation) or independent from those of the entity (foreign entity)#.
- The financial statements of integrated foreign operations are translated into the entity's functional currency using the same method that is used to translate foreign currency transactions (i.e., as if the entity had entered into those transactions itself).

Forthcoming requirements

IAS 21 Under the revised standard, there is no distinction between foreign operations that are integral to the operations of the reporting entity and foreign entities. An entity that was an integral foreign operation under previous versions of the standard normally has a functional currency that is the same as that of its parent.

- The financial statements of independent foreign operations (foreign entities) are translated into the entity's functional currency using a method known as the foreign entity method, which recognises that the effect of translating the assets, liabilities and results of the foreign operation should not impact the profit reported by the entity itself.
- The result of all of the above is that the entity will have prepared its financial statements or consolidated financial statements in the functional currency of the parent entity.
- As a last step, the entity *may* translate its financial statements or consolidated financial statements into a different presentation currency. The method of translation is similar to, but not exactly the same as, the method used to translate foreign entities#.

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Forthcoming requirements

IAS 21 The revised standard changes the method of translating an entity's (including its foreign operations) financial statements from its functional currency to its presentation currency. The revised method is consistent with the methodology previously used to translate the financial statements of a foreign entity.

2.7.3 Translation of foreign currency transactions

At the transaction date

IAS 21.21, 22 Each foreign currency transaction is recorded in the entity's functional currency at the rate of exchange at the date of the transaction, or at rates that approximate the actual exchange rates. An average exchange rate for a specific period may be a suitable approximate rate for transactions during that period, particularly when exchange rates do not fluctuate significantly.

For example, an entity purchases inventory at a price of foreign currency (AC) 100. The spot exchange rate at the date of acquisition is AC 1 to functional currency (BC) 2. In anticipation of the transaction the entity entered into a forward exchange contract to purchase AC 100 for an amount of BC 180. In this case the initial cost of the inventory is BC 200. The appropriate accounting for the forward exchange contract is discussed in 3.6.

In some countries there are dual exchange rates: the official exchange rate and an unofficial parallel exchange rate. In our view, individual transactions should be translated using the exchange rate that will be used to determine the rate at which the transaction is settled. This normally will be the official rate. However, use of an unofficial exchange rate may be more appropriate in very limited circumstances, for example, when it is:

- a legal rate (i.e., domestic and foreign entities can and do purchase and sell foreign currency on a local market at this rate legally); or
- the only rate at which the transaction can be settled because long-term lack of liquidity in the exchange market means that sufficient amounts of cash are and will not be available at the official rate.

At the reporting date

General requirements

IAS 21.23 At the reporting date assets and liabilities denominated in a currency other than the entity's functional currency are translated as follows:

- monetary items are translated at the exchange rate at the balance sheet date;
- non-monetary items carried at historical cost are not retranslated – they remain at the exchange rate at the date of the transaction; and
- non-monetary items carried at fair value are translated at the exchange rate when the fair value was determined.

Monetary versus non-monetary

IAS 21.8, 16 Monetary items are defined as money held, and assets and liabilities to be received or paid in fixed or determinable amounts of money. Examples of non-monetary items include:

- prepaid expenses and income received in advance, on the basis that no money will be paid or received in the future; and
- equity securities held and share capital, on the basis that any future payments are not fixed or determinable.

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IAS 39.16 E.3.4 A debt security is classified as a monetary item because its contractual cash flows are fixed or determinable. There is no exemption from this classification when the security is classified as available-for-sale even though it can be argued that any future payments are not fixed or determinable in that case.

The appropriate classification of deferred taxes is not clear in IFRSs; actually it comprises both monetary and non-monetary components (see 3.12). However, in our experience normally it is classified as a monetary item.

IAS 39.16 E.3.2 When a non-monetary asset is stated at fair value, an issue arises as to how to distinguish the change in fair value from the related foreign exchange gain or loss. The IAS 39 implementation guidance includes an example in respect of financial instruments, which commonly is applied to non-financial instruments.

For example, an entity acquires investment property for AC 1,000 when the exchange rate is AC 1:BC 1.5. Therefore, the property is recorded initially at BC 1,500. The entity states all investment property at fair value (see 3.4). At the reporting date the fair value of the property has increased to AC 1,200 and the exchange rate is now AC 1:BC 1.7. In our view, the foreign exchange gain or loss is the difference between the carrying amount recorded initially, and the carrying amount at the reporting date, prior to taking into account changes in fair value, in accordance with the exchange rate at the reporting date (i.e., 200 (1,000 x 1.7 - 1,500)). Therefore, the fair value gain is 340 (1,200 x 1.7 - 1,500 - 200). Although both the exchange gain and the change in the fair value of the investment property are recognised in the income statement, they are disclosed separately.

Intra-group transactions

IAS 21.45 Although intra-group balances are eliminated on consolidation (see 2.5), any related foreign exchange gains or losses will not be eliminated. This is because the group has a real exposure to a foreign currency since one of the entities will need to obtain or sell foreign currency in order to settle the obligation or realise the proceeds received.

For example, parent P has a functional currency of AC, and subsidiary S has a functional currency of BC. P, whose balance sheet date is 31 December, lends AC 100 to S on 1 June 2004. S converted the cash received into BC on receipt.

	AC		*BC*
Exchange rate at 1 June 2004	1	=	1.5
Exchange rate at 31 December 2004	1	=	2.0

Entries in S

	Debit	*Credit*
Cash	BC 150	
Intra-group payable		BC 150
Exchange loss	BC 50	
Intra-group payable		BC 50

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In the second entry above the liability is remeasured at 31 December 2004 and a translation loss is recorded.

Entries in P

	Debit	*Credit*
Intra-group receivable	AC 100	
Cash		AC 100

On consolidation the BC 200 will convert to AC 100 (see 2.7.5) and the receivable and payable will eliminate. However, an exchange loss equivalent to BC 50 will remain on consolidation. This is appropriate because S will need to obtain AC in order to repay the liability; therefore the group as a whole has a foreign currency exposure. It is not appropriate to transfer the exchange loss to equity on consolidation unless the loan forms part of P's net investment in S (see below).

Recognition of foreign exchange gains and losses

IAS 21.28, SIC 11 (1998)

Foreign exchange gains and losses generally are recognised in the income statement. The only exceptions relate to foreign currency liabilities that are hedges of a net investment in a foreign entity (see 3.6), certain losses on severe currency devaluations# and monetary items that in substance form part of the net investment in a foreign entity#.

Forthcoming requirements

IAS 21

The revised standard deletes the exemption for exchange differences resulting from a severe devaluation or depreciation of a currency against which there is no means of hedging. As a result, these gains and losses must be recognised in the income statement.

Severe currency devaluations#

SIC 11.3-6 (1998)

In respect of severe currency devaluations, exchange losses may be capitalised when all the following conditions are met:

- an asset was purchased within the 12 months prior to the devaluation;
- the liability arising on the acquisition could not have been, and still cannot be, settled; and
- it was impracticable to hedge the exchange risk prior to the devaluation.

These conditions are expected to be met only in rare circumstances. However, if they are, the foreign exchange losses on that liability may be capitalised as part of the cost of the related asset.

Forthcoming requirements

IAS 21.28

The revised standard deletes the exemption that exchange differences resulting from a severe devaluation or depreciation of a currency against which there is no means of hedging. As a result these gains and losses must be recognised in the income statement.

Net investment in a foreign entity

IAS 21.15, 32

Foreign exchange gains and losses arising from monetary items that in substance form part of the net investment in a foreign entity are recognised directly in equity (in the foreign currency translation reserve – see 2.7.5). In order to qualify, settlement of the monetary item must be neither planned nor likely in the foreseeable future.

For example, parent P has a functional currency of AC, and subsidiary S has a functional currency of BC. P sells inventory to S for BC 300. At the balance sheet date S has not yet paid the amount owing to P, but payment is expected to be made in the foreseeable future. Accordingly the exchange gain or loss incurred by P should be recognised in the income statement. Even if repayment was not due for three years (for example) or even longer, in our view if repayment still is planned then the gain or loss should be recognised in the income statement.

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In addition to the trading balances between P and S, P lends an amount of BC 500 to S that is not expected to be repaid in the foreseeable future; P regards the amount as part of its permanent funding to S. In this case the exchange gain or loss incurred by P on the BC 500 loan should be recognised directly in equity, both in P's own financial statements and in the consolidated financial statements#.

If the loan in this example were denominated in AC rather than in BC (i.e., in P's functional currency), S would incur an exchange gain or loss. In our view, S must recognise the gain or loss in the income statement in its own financial statements; however, on consolidation the amount would be reclassified as equity. Our view is based on the fact that S is not the entity that has an investment in a foreign entity; rather, it is the recipient of the funding. However, from the group's point of view the funding does relate to an investment in a foreign entity.

If the exchange gain or loss incurred by S is reclassified to equity on consolidation, any related deferred or current tax also is reclassified to equity (see 3.12 and 4.7).

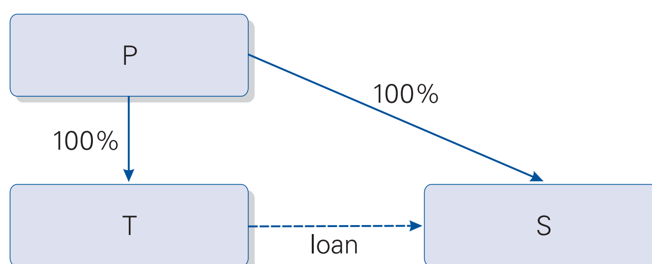
In this example we believe that S could avoid recognising an exchange gain or loss only if the funding was not considered to be a financial liability in accordance with IAS 32 (see 3.6), which is unlikely to be the case in practice. In this case the funding would be classified as a capital contribution in S's financial statements and would not be retranslated subsequent to initial recognition (see above under *At the reporting date*).

Forthcoming requirements

IAS 21.32, 33

Under the revised standard, exchange gains and losses on P's permanent funding to S may be recognised in equity only in P's consolidated financial statements. In addition, the revised standard requires that, if the loan is denominated in neither P's nor S's functional currency, all exchange gains and losses are recognised in the income statement.

Changing the facts of the above example, suppose that the "permanent" funding extended to S is made via another entity in the group T rather than from P directly; this is done for tax reasons.



In our view, any exchange difference in respect of the loan may be reclassified as equity on consolidation because from the group's point of view the funding does relate to an investment in a foreign entity. However, in the individual financial statements of T and S we believe that any exchange difference should be recognised in the income statement because neither entity holds the net investment.

Presentation in the income statement

IAS 21.52

Although IAS 21 requires disclosure of the amount of exchange differences recognised in profit or loss for the period, the standard does not specify where in the income statement such differences should be presented.

In our experience the most common practice is for all exchange differences to be included in the income statement as part of finance costs (see 4.6). However, it also is acceptable to allocate the

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exchange differences to the various line items in the income statement. For example, an entity might classify exchange differences arising from the purchase of inventory that is sold during the period as part of cost of goods sold; exchange differences arising from trade receivables as part of revenue; and exchange differences arising from loans as part of finance costs. If exchange differences are allocated in this way, this must be done consistently from period to period; and if the amounts involved are material, it may be necessary to disclose the entity's allocation policy in the financial statements.

2.7.4 Foreign operations

IAS 21.8

A foreign operation of an entity is a subsidiary, associate, joint venture or branch whose activities are conducted in a foreign currency. While it is clear what constitutes a subsidiary (see 2.5), associate (see 3.5) or joint venture (see 3.5), a branch is not defined under IFRSs and issues arise regarding the level of activity that can comprise a foreign operation (see below under *Issues in identifying foreign entities*).

Classifying a foreign operation

IAS 21.23 (1993)

A foreign operation is classified as either:

- an integrated foreign operation when its activities are integral to those of the reporting entity; or
- a foreign entity when its activities are not integral to those of the reporting entity#.

Forthcoming requirements

IAS 21

In the revised standard the concept of integrated foreign operations no longer exists. However, an integrated foreign operation is likely to have the same functional currency as the reporting entity. When this is the case, the accounting result generally is similar to the previous treatment as an integral foreign operation (see 2.7.5).

IAS 21.23-26 (1993)

IAS 21 gives a list of factors to consider in distinguishing between an integrated foreign operation and a foreign entity. The key driver behind all of these factors is determining whether the foreign operation simply is an extension of the operations of the reporting entity, such that changes in the exchange rate between the two countries have an almost immediate effect on the cash flows of the reporting entity.

In practice more entities are likely to be classified as foreign entities.

Forthcoming requirements

IAS 21.11

The revised IAS 21 provides additional guidance on the determination of the functional currency in the case of a foreign operation and whether its functional currency is the same as that of the reporting entity:

- Whether the foreign operation operates as an extension of the reporting entity, or whether the entity operates with a significant degree of autonomy.
- The proportion of transactions with the reporting entity.
- Whether the foreign operation's cash flows directly affect the cash flows of the reporting entity and whether the foreign operation's cash flows can be remitted to the parent.
- Whether the foreign operation can service its debt from its own cash flows without financing by the reporting entity.

IAS 21.9, 12

When the indicators are mixed and the functional currency is not obvious, the revised IAS 21 stresses that priority should be given to indicators that focus on the primary economic environment, such as which currency mainly influences sales prices for goods and services, the country whose competitive forces and regulations mainly determine the sales prices of its goods and services and the currency that is the main influence on labour, material and other costs of providing goods or services.

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Functional currency of a foreign operation#

Integrated foreign operation

Because an integrated foreign operation effectively is an extension of the operations of the reporting entity, its functional currency is likely to be the same as that of the reporting entity.

Foreign entity

SIC 19 App B (1998)

Because a foreign entity is independent of the operations of the reporting entity, it is more likely that an integrated foreign operation to have its own functional currency (see above).

Forthcoming requirements

IAS 21.11, 12

The revised IAS 21 provides additional guidance on the determination of functional currency in the case of a foreign operation. The revised standard also places greater emphasis on the currency that determines the pricing of transactions than on the currency in which transactions are denominated. An entity may conclude that its functional currency is not that which it had concluded under previous versions of the standard.

Issues in identifying foreign entities

The issues discussed below arise only in respect of foreign entities because each foreign entity has its own functional currency and exchange differences on translation to the functional currency of the reporting entity are not recognised in the income statement (see 2.7.5).

Separate legal entity

In our view, the analysis of whether a foreign operation is a foreign entity should be based on the substance of the relationship between the foreign operation and the reporting entity, rather than the legal structure of the foreign operation. Accordingly, we believe that a single legal entity may be comprised of multiple foreign entities with different multiple functional currencies in certain circumstances.

For example, parent P is based in the United States and has as its functional currency the US dollar. Subsidiary S is based in the United Kingdom. S has three distinct operations (X, Y and Z), which are conducted from the United Kingdom but under different economic environments as a result of differences in the nature of their products and markets. Separate accounting records are kept for each of the operations. In our view, the functional currency of each of X, Y and Z should be determined separately *if* they each qualify as foreign entities (see above under *Classifying a foreign operation*).

Care should be taken in assessing whether X, Y and Z are foreign entities. The fact that they are part of the same legal entity normally will make it harder to show that any of them is independent of the reporting entity. In particular, if separate accounting records for each operation are not kept or if their operations and cash flows are managed on a unified basis, our view is that it would not be appropriate to conclude that each is a foreign entity.

An operation

In our view, a foreign operation must include operating activities. Consistent with our views on business combinations, we do not believe that an *ad hoc* collection of assets comprises an operation.

For example, a reporting entity in New Zealand sets up a SPE to finance the acquisition of a production plant. The SPE obtains a loan, buys the plant and then leases the plant to the entity on normal commercial terms; the lease payments are sufficient to finance interest and capital repayments on the loan. All of these transactions are denominated in US dollars. The SPE operates on auto-pilot (see 2.5). The rest of the reporting entity's operations are denominated in New Zealand dollars.

In our view, the SPE is not a foreign entity because its activities are not carried out with a significant degree of autonomy from those of the reporting entity. The SPE was established with the objective of effecting the lease and obtaining finance for the reporting entity's plant and, in substance, the SPE simply holds core assets of the reporting entity and does not have any independent activities.

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Therefore, it is not relevant that substantially all the SPE's assets, liabilities, revenues and expenses are denominated in a currency different from that of the reporting entity. However, if the plant was leased to a third party, with only residual benefits flowing to the New Zealand entity, then in our view, the SPE would be a foreign entity.

We believe that the reporting entity and the SPE will have the same functional currency, which will be determined by analysing the combined operations (see above under *Integrated foreign operation*).

2.7.5 Translation of foreign currency financial statements

Integrated foreign operations#

IAS 21.27 (1999)

The financial statements of an integrated foreign operation are translated in the same way as foreign currency transactions, and the resulting exchange differences are recognised in the same way (see 2.7.3).

Forthcoming requirements

IAS 21

In the revised standard the concept of integrated foreign operations no longer exists. However, an integrated foreign operation is likely to have the same functional currency as the reporting entity. When this is the case, the accounting result generally is similar to the previous treatment as an integral foreign operation.

Foreign entities

IAS 21.39, 52, 7.26, 27

The financial statements of foreign entities are translated as follows:

- assets and liabilities are translated at the exchange rate at the balance sheet date;
- items of revenue and expense are translated at exchange rates at the dates of the relevant transactions, although appropriate average rates may be used;
- the resulting exchange differences are recognised directly in equity, and are presented as a separate component of equity (generally referred to as the foreign currency translation reserve or currency translation adjustment); and
- cash flows are translated at exchange rates at the dates of the relevant transactions, although an appropriate average rate may be used (see 2.3).

In addition, although IAS 21 is not explicit on these points:

- capital transactions (e.g., dividends) are translated at exchange rates at the dates of the relevant transactions; and
- components of equity at the balance sheet date are not retranslated.

In practice capital transactions are translated using exchange rates at the dates of the relevant transactions. In our view, this may be approximated by use of an average rate, as used for translation of revenue and expenses, when appropriate (e.g., translation of gains and losses on available-for-sale investments).

IAS 21.33 (1993)

Goodwill and fair value purchase accounting adjustments relating to a foreign entity may be either included as part of the retranslated assets and liabilities or recognised as an asset of the reporting entity (and therefore never retranslated)#.

Forthcoming requirements

IAS 21.47

The revised standard requires that goodwill and fair value adjustments to assets and liabilities that arise on the acquisition of a foreign entity be translated at the closing rate (i.e., treated as part of the assets and liabilities of the acquired entity).

IAS 21.46

When the balance sheet date of a foreign entity that is a subsidiary, associate or joint venture is prior to that of the parent (see 2.5 and 3.5), adjustments should be made for significant movements in exchange rates up to the balance sheet date of the parent for group reporting purposes.

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Using average exchange rates

IAS 21.22 In determining whether average rates may be used to translate revenues and expenses (and cash flows), fluctuations in the exchange rate and the volume and size of transactions should be considered. For example, if the flow of transactions (by size and volume) is fairly stable over the period and exchange rates have not altered significantly, it may be acceptable to update exchange rates only quarterly; in this case the translated amounts for each quarter would be combined to obtain the annual total. However, at the other extreme daily exchange rates might be used for an entity with complex operations where there is an uneven flow of transactions, or when exchange rates are not stable.

Dual exchange rates

As noted above (under 2.7.3), in some countries there are dual exchange rates: the official exchange rate and an unofficial parallel exchange rate. In our view, when a foreign entity operates in a dual exchange rate environment, subject to the considerations highlighted above, its financial statements should be translated using the rate applicable to dividends and capital repatriation since this is how the investment in the foreign entity will be recovered.

In our view, the financial statements should disclose the reasons for not applying an official exchange rate as well as information about the rate used, if a rate other than the official rate has been used.

Foreign currency translation reserve

IAS 21.41 The net exchange difference that is recognised in the foreign currency translation reserve in each period represents the following:

- in respect of revenue, expenses and capital transactions, the difference between translating these items at actual or average exchange rates, and using the exchange rate at the balance sheet date; and
- in respect of the opening balance of equity (excluding the foreign currency translation reserve), the difference between translating these items at the rate at the balance sheet date at the end of the previous period, and using the rate at the balance sheet date at the end of the current period.

The proof of the foreign currency translation reserve is illustrated below (under *Worked example*).

In addition, the foreign currency translation reserve may include exchange differences arising from loans that form part of the parent's net investment in the foreign entity (see 2.7.3) and gains and losses relating to hedges of a net investment in a foreign entity (see 3.6).

In some cases the foreign currency translation reserve may have a debit balance. A debit balance on the reserve is acceptable under IFRSs and the balance should not be transferred to the income statement simply because it represents a "loss".

IAS 21.41 When there is a minority interest in a foreign entity subsidiary, an appropriate portion of the foreign currency translation reserve is attributed to the minority interest.

Hyperinflation

IAS 21.36 (1993) When the functional currency of a foreign entity is hyperinflationary, the foreign entity's financial statements first must be restated into the measuring unit current at the balance sheet date (see 2.4). All amounts in the financial statements (including comparatives) then are translated using the exchange rate at the balance sheet date of the current reporting period#.

For example, an entity has prepared financial statements for the year ended 31 December 2004 with comparative information for the year ended 31 December 2003. In accordance with IAS 29 the 2003 and 2004 financial statements both have been restated to be presented in the measuring unit current

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at 31 December 2004. Accordingly the relevant exchange rate at 31 December 2004 is applied in translating both years of financial information.

Forthcoming requirements

IAS 21.42(b) The revised standard requires that comparative figures of the financial statements of a foreign entity whose functional currency is hyperinflationary be translated by using the exchange rate at the comparative reporting date if the presentation currency is *not* hyperinflationary.

Worked example

The following example illustrates the translation of the financial statements of a foreign entity. As a result of the translation process, the exchange difference recognised in the foreign currency translation reserve is a balancing figure; however, as noted above the amount can be proved, and this is illustrated in the example. In addition, an exchange difference will arise in reconciling the opening and closing balances of the various assets and liabilities; the proof of these exchange differences is illustrated below using property, plant and equipment as an example.

The subsidiary was acquired on 1 January 2003. Revenues and expenses since acquisition have been translated using annual average exchange rates (see above). No dividends have been paid since acquisition. The subsidiary's functional currency is BC; the parent entity's functional currency is AC.

	BC	*AC*
Exchange rate at 1 January 2003	1	1.0
Average exchange rate during 2003	1	1.25
Exchange rate at 31 December 2003	1	1.5
Average exchange rate during 2004	1	2.0
Exchange rate at 31 December 2004	1	2.5

The above rates are illustrative only and are not intended to indicate hyperinflation.

Subsidiary balance sheet – 2004

	BC	*Rate*	*AC*	
Share capital	400	1.0	400	
Retained earnings – at acquisition	2,200	1.0	2,200	
Earnings of 2003 that were retained	900	1.25	1,125	
Net profit for the year – 2004	1,300		2,600	See below
Foreign currency translation reserve	-		5,675	See below
Equity	4,800		12,000	
Property, plant and equipment	2,800	2.5	7,000	
Other assets and liabilities	2,000	2.5	5,000	
Net assets	4,800		12,000	

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Subsidiary income statement – 2004

Revenue	2,000	2.0	4,000
Depreciation	(200)	2.0	(400)
Other expenses	(500)	2.0	(1,000)
Net profit for the year	1,300		2,600

The proof of the foreign currency translation reserve is determined by taking the difference between the actual exchange rate used to translate the item and the closing exchange rate, and multiplying this by the balance of the item in BC.

Proof of translation reserve	*Actual*	*Closing*	*Difference in rate*	*Amount in BC*	*Difference in AC*
Share capital	1.0	2.5	1.5	400	600
Retained earnings – at acquisition	1.0	2.5	1.5	2,200	3,300
Earnings of 2003 that were retained	1.25	2.5	1.25	900	1,125
Net profit for the year – 2004	2.0	2.5	0.5	1,300	650
Translation reserve					5,675

While this proof is cumulative for the period to the end of 2004 to match the example, in practice the proof would be done on an annual basis.

IAS 16.73 The reconciliation of property, plant and equipment will appear as follows in the notes to the financial statements:

Property, plant and equipment	*AC*	
Opening balance before depreciation	4,500	(BC2,800 + BC200) x 1.5
Depreciation	(400)	BC200 x 2
Foreign exchange difference	2,900	See below
Closing balance	7,000	

The proof of the exchange difference in the reconciliation of property, plant and equipment is determined by taking the difference between the actual exchange rate used to translate the item and the closing exchange rate, and multiplying this by the balance of the item in BC.

Proof of exchange difference	*Actual*	*Closing*	*Difference in rate*	*Amount in BC*	*Difference*
Opening balance	1.5	2.5	1.0	3,000	3,000
Current year depreciation	2.0	2.5	0.5	200	(100)
Exchange difference					2,900

Change in the classification of a foreign operation#

IAS 21.39 (1993) If there is a change in the classification of a foreign operation, from an integrated foreign operation to a foreign entity or *vice versa*, the new translation procedures are applied from the date of the change. The difference between the two methods that needs to be dealt with when there is a change in classification is the translation of non-monetary assets and liabilities. They are retranslated at closing rates in the case of a foreign entity, but not in the case of an integrated foreign operation (see above).

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Forthcoming requirements

IAS 21.35, 37

Under the revised standard, a change in classification is simply a change in functional currency – retranslation occurs at the spot rate and at the date of change and the normal consolidation requirements apply (see 2.5).

Change from integrated foreign operation to foreign entity#

IAS 21.40 (1993)

When an integrated foreign operation becomes a foreign entity, non-monetary assets and liabilities must be retranslated using closing exchange rates. In the example below, this results in the carrying amount of the foreign operation's non-monetary assets and liabilities increasing from AC 600 to AC 900. The difference of AC 300 is recognised directly in equity – in the foreign currency translation reserve.

Forthcoming requirements

IAS 21.35, 37

Under the revised standard, a change in classification is simply a change in functional currency – retranslation occurs at the spot rate and at the date of change and the normal consolidation requirements apply (see 2.5).

	Before change AC	*After change AC*
Equity	1,000	1,000
Foreign currency translation reserve	-	300
	1,000	1,300
Monetary assets and liabilities	400	400
Non-monetary assets and liabilities	600	900
	1,000	1,300

Forthcoming requirements

IAS 21.35, 37

Under the revised standard, a change in classification is simply a change in functional currency – retranslation occurs at the spot rate and at the date of change and the normal consolidation requirements apply (see 2.5).

Change from foreign entity to integrated foreign operation

IAS 21.40 (1993)

When a foreign entity becomes an integrated foreign operation, non-monetary assets and liabilities no longer will be retranslated. However, previous retranslations are not reversed; instead, the existing carrying amounts of the non-monetary assets and liabilities become their deemed historical cost, and the balance in the foreign currency translation reserve remains there until the investment is disposed of (see 2.7.7).

	Before change AC	*After change AC*
Equity	1,000	1,000
Foreign currency translation reserve	300	300
	1,300	1,300
Monetary assets and liabilities	400	400
Non-monetary assets and liabilities	900	900
	1,300	1,300

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2.7.6 Translation from functional to presentation currency

General requirements

SIC 30.6 (2001)

When an entity presents its financial statements in a presentation currency that is different from its functional currency, the translation procedures are the same as those for translating foreign entities (see 2.7.5) except that the components of equity, other than the current year's profit or loss and the foreign currency translation reserve, are retranslated at the closing exchange rate#.

Forthcoming requirements

IAS 21.39

The method of translating an entity's financial statements from its functional currency to its presentation currency has been changed under the revised standard to be consistent with the methodology previously used to translate the financial statements of a foreign entity. The revised standard is silent regarding the translation of components of equity, other than the current year's profit or loss and the foreign currency translation reserve. In our view, the method of translation to any presentation currency should be consistent with translation of a foreign entity for consolidation purposes.

The following example is similar to the one used above to illustrate the translation of foreign entities. The entity's functional currency is FC; however, the financial statements will be presented in presentation currency (PC). Revenues and expenses since acquisition have been translated using an annual average exchange rate (see 2.7.5).

	FC	*PC*
Exchange rate at 31 December 2003	1	1.5
Average exchange rate during 2004	1	2.0
Exchange rate at 31 December 2004	1	2.5

Balance sheet – 2004

	FC	*Rate*	*PC*	
Share capital	400	2.5	1,000	
Opening retained earnings	3,100	2.5	7,750	
Net profit for the year – 2004	1,300		2,600	See below
Foreign currency translation reserve	-		650	See below
Equity	4,800		12,000	
Property, plant and equipment	2,800	2.5	7,000	
Other assets and liabilities	2,000	2.5	5,000	
Net assets	4,800		12,000	

Income statement – 2004

Revenue	2,000	2.0	4,000
Depreciation	(200)	2.0	(400)
Other expenses	(500)	2.0	(1,000)
Net profit for the year	1,300		2,600

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The proof of the foreign currency translation reserve is determined by taking the difference between the actual exchange rate used to translate an item and the closing exchange rate, and multiplying this by the balance of the item in FC.

Proof of translation reserve	*Actual*	*Closing*	*Difference in rate*	*Amount in FC*	*Difference in PC*
Net profit for the year – 2004	2.0	2.5	0.5	1,300	650
Translation reserve					650

Implications for the preparation of consolidated financial statements#

The difference between translation of financial statements from a measurement currency to a presentation currency and translation of a foreign entity's financial statements has important implications for the preparation of consolidated financial statements where the group's presentation currency differs from the functional currency of the parent#.

For example, parent P has a functional currency of euro, but presents its financial statements and consolidated financial statements in US dollars. Subsidiary S is a foreign entity whose functional currency is Thai bhat. For practical reasons it would be easiest for the Thai subsidiary's financial statements to be translated directly into US dollars in preparing the consolidated financial statements.

However, under IAS 21 and SIC–30 the translation should be carried out as follows:

- First, translate from Thai bhat to euro following the procedures for foreign entities; in particular, post-acquisition components of equity should not be retranslated (i.e., they will be stated at historical exchange rates – see 2.7.5).
- Second, translate from euro to US dollar following the procedures in SIC–30 (see above); in particular, post-acquisition components of equity should be retranslated.

The difference between following IAS 21 / SIC–30 and translating directly under IAS 21 is in respect of the components of equity, and can be summarised as follows:

- Using the required method of applying IAS 21 and then SIC–30, equity components will be restated for changes in the euro / US dollar exchange rate only.
- If the Thai bhat financial statements are translated directly into US dollars, the equity components will be restated for changes in the Thai bhat / US dollar exchange rate.

Whether or not this difference is material will depend upon the relative changes in the exchange rates. In practice it is possible to translate directly and then adjust the post-acquisition components of equity.

Forthcoming requirements

IAS 21 This difference has been removed by the revised standard as it provides only one method of translation from a functional currency to a presentation currency.

Hyperinflation

SIC 30.7 (2001) When the entity's functional currency is hyperinflationary, all items in the financial statements (current period and comparatives) are translated into the presentation currency at the closing rate at the end of the most recent period presented after being restated for the effects of inflation#.

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Forthcoming requirements

IAS 21.42 When an entity's functional currency is hyperinflationary, all amounts of the current year are translated at the closing rate into the presentation currency at the date of the most recent balance sheet. However, the revised standard requires the comparative amounts of the financial statement to be translated using the exchange rate at the comparative reporting date if the presentation currency is *not* hyperinflationary.

2.7.7 Sale or liquidation of a foreign entity

IAS 21.48, 49 The cumulative exchange differences relating to a foreign entity that have been included in the foreign currency translation reserve should be transferred to the income statement when the foreign entity is disposed of. In the case of a partial disposal, the balance of the foreign currency translation reserve is reduced proportionately.

For example, parent P owns 100 per cent of subsidiary S. P sells 20 per cent of its investment. Therefore, 20 per cent of the balance in the foreign currency translation reserve is transferred to the income statement. The standard does not specify where in the income statement this item is included. In our experience typically it is included as part of the gain or loss on the disposal.

When the parent has made a loan to a foreign entity that is classified as part of its net investment and exchange differences are recognised in the foreign currency translation reserve (see 2.7.3), in our view, any repayment of the loan constitutes a partial disposal of the foreign entity.

For example, parent P subscribed 1,000 in return for a 100 per cent interest in subsidiary S, and extended "permanent" funding of a further 500 at the same time. If S repays the loan of 500, we believe that one third of the balance in the foreign currency translation reserve should be transferred to the income statement.

If P had extended the "permanent" funding some time after the original investment, we believe that the amount to be transferred to the income statement should be one third of the change in the balance of the foreign currency translation reserve that arose while the funding was outstanding.

A similar issue in respect of determining the amount of the transfer arises when there have been past step acquisitions (see 2.6). In such cases we believe that it is acceptable to transfer a percentage of the balance of the foreign currency translation reserve to the income statement. For example, parent P acquired a 60 per cent interest in subsidiary S in 1998 and a further 10 per cent interest in 2000; in 2004 P disposes of 30 per cent of its interest in S. In our view, the entity may transfer 30 per cent of the balance in the translation reserve to the income statement without trying to identify specifically the shares that have been disposed of and the associated exchange differences.

IAS 21.49 In the event of an impairment loss, the standard is clear that this does not constitute a partial disposal and no amount of the foreign currency translation reserve should be transferred to the income statement.

In our view, a major restructuring that results in reducing the scale of operations of a foreign entity does not in itself trigger any amount of the foreign currency translation reserve to be transferred to the income statement because the parent has not realised its investment in the foreign entity. However, if cash reserves of the foreign entity are paid out as a dividend following the restructuring, this constitutes a disposal to the extent that it constitutes a return of the investment.

2.7.8 Convenience translations

A convenience translation occurs when an entity decides to present financial statements in addition to the financial statements required to be presented in accordance with IFRSs. For example, an entity has a functional currency of Danish krone and a presentation currency of euro; in addition it wishes to

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show US dollar figures for the most recent year's primary financial statements, but it will not publish a full set of US dollar financial statements.

SIC 30.10 (2001)

In this case the method of translating the information from Danish krone to US dollars is not specified, but a number of detailed disclosures are required. In particular, the convenience translation must be identified clearly as being supplementary information to distinguish it from the IFRS financial statements (i.e., it cannot take the place of the IFRS financial statements presented in euro)#.

Forthcoming requirements

IAS 21.39, 42, 57

Although convenience translations continue to be allowed under the revised standard, there is a difference between convenience translation and translation to presentation currency. An entity that presents its financial statements in a currency that is different from its functional currency should describe the financial statements as complying with IFRSs only if they comply with the translation method as set out in the revised IAS 21. If an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and does not comply with the translation method set out under revised IAS 21 then it needs to provide disclosures (e.g., that the information in the convenience translation is supplementary, what the convenience currency is and the functional currency and method of translation used). The convenience translation may be for only selected data. A convenience translation can be provided only as supplemental information (see 5.8).

2.7.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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2.8 Prior period adjustments and other accounting changes
(IAS 1, IAS 8)

Overview

- **Most accounting policy changes and all corrections of fundamental errors may be made either by adjusting opening retained earnings and restating comparatives when practicable, or by making an adjustment in the current year#.**
- **Errors that are not "fundamental" are adjusted in the current year#.**
- **Changes in accounting estimates are accounted for prospectively.**
- **Comparatives are restated when practicable if the classification or presentation of items in the financial statements is changed.**

Forthcoming requirements
In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Error*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standards:

- eliminate the option to make an adjustment in the current year for accounting policy changes and the correction of fundamental errors; and
- eliminate the distinction between fundamental errors and other material errors.

2.8.1 Prior period adjustments

IAS 8.22, 23, 42 A prior period adjustment is made by adjusting the opening balance of retained earnings and restating the comparative financial statements where practicable. A prior period adjustment is the benchmark treatment# for:

- the correction of fundamental errors#; and
- most changes in accounting policy.

IAS 8.38, 54 (1993) In both cases the allowed alternative treatment is to calculate the effect of the adjustment retrospectively, but to recognise the cumulative effect of the adjustment in the current period's income statement#.

IAS 8.13 Accounting policies, including those for errors and for changes in accounting policy must be applied consistently.

IAS 8.52, 56 (1993) However, under both the benchmark and allowed alternative treatments for a change in accounting policy, the change is accounted for prospectively if the adjustment to opening retained earnings cannot be determined reasonably.

Forthcoming requirements
IAS 8 The revised standard removes the allowed alternative of recognising the cumulative effect in the current period. It eliminates the distinction between fundamental errors and other material errors.

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2.8.2 Fundamental errors#

Definition

IAS 8.51 Errors result from the misapplication of policies or misinterpretation of facts and circumstances that exist at the reporting date. Examples include mathematical mistakes, fraud and oversight.

IAS 8.6 (1993) An error is fundamental when it has such a significant effect on the financial statements of one or more prior periods that those financial statements no longer can be considered to have been reliable at the date of their issue. An error that is not fundamental is corrected in the current period.

There is no additional guidance in IFRSs that helps distinguish between an error and a fundamental error. This is a difficult area of accounting and significant judgement is required in assessing whether an error is fundamental, or simply material, to the previously issued financial statements.

Forthcoming requirements

IAS 8.41, 42 The distinction between fundamental errors and other material errors has been eliminated. All errors are dealt with in the same way under the revised standard (i.e., as a prior period adjustment).

Financial statements containing material errors do not comply with IFRSs. Potential current year errors are corrected before the financial statements are authorised for issue. Material prior period errors are corrected by restating the comparative information presented in the financial statements for that subsequent period.

In the case of correction of a material prior period error, correction is made by either:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- if the error occurred before the earliest prior period presented, by restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

The following example illustrates the correction of a fundamental error in accordance with both the benchmark and allowed alternative treatments. For simplicity, any impact on current and deferred tax has been ignored (see 4.7 and 3.12).

During 2004 entity A discovered that prepayments of 400,000 made during 2002 had not been debited to the income statement as the related expenses were incurred. Expenses of 100,000 were incurred during 2002; 250,000 during 2003; and 50,000 during 2004. The directors of A consider the error to be "fundamental".

Extract from draft 2004 financial statements before correction of the error

	Draft 2004	*2003*
Extract from income statement		
Revenue	6,000	4,000
Expenses	(5,500)	(3,600)
Net profit	500	400
Extract from statement of changes in equity		
Opening retained earnings	14,400	14,000
Current year net profit	500	400
Closing retained earnings	14,900	14,400

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Correction of the fundamental error – benchmark treatment

In accordance with the benchmark treatment the opening balance of retained earnings is adjusted and comparatives are restated when practicable to reflect the correction of the error. The restatement should reflect any tax effects (see 3.12 and 4.7), which were ignored for the purposes of this example.

	2004	*2003 Restated*
Extract from income statement		
Revenue	6,000	4,000
Expenses	(5,550)	(3,850)
Net profit	450	150
Extract from statement of changes in equity		
Opening retained earnings as reported previously	14,400	14,000
Correction of an error (note reference)	(350)	(100)
Opening retained earnings restated	14,050	13,900
Current year net profit	450	150
Closing retained earnings	14,500	14,050

IAS 8.49 In restating the comparatives the adjustment will be included in the appropriate line of the income statement in the usual way (see 4.1); for example, if the expense in this case was insurance of A's head office and A classified its expenses by function, the expense probably would be included in administrative expenses. In addition, the financial statements will include full disclosure regarding the error and the adjustments made to correct it.

IAS 8.16 Although not mentioned specifically in the standard, the implementation guidance to IAS 8 shows the restated comparative financial statements with the heading "restated". In our view, this is necessary in order to highlight users to the fact that the comparative financial statements are not the same as the financial statements published previously.

IAS 8.34 (1993) If the circumstances were different and the amount of the error could not be allocated between the comparative period and periods prior to that, the error would be corrected by adjusting opening retained earnings at the start of the current period#.

	2004	*2003*
Extract from income statement		
Revenue	6,000	4,000
Expenses	(5,550)	(3,600)
Net profit	450	400
Extract from statement of changes in equity		
Opening retained earnings as reported previously	14,400	14,000
Correction of an error (note reference)	(350)	-
Opening retained earnings restated	14,050	14,000
Current year net profit	450	400
Closing retained earnings	14,500	14,400

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Forthcoming requirements

IAS 8.42 The revised standard requires that material errors be corrected by restating the opening balance of retained earnings and comparatives unless this is impracticable.

IAS 8.44 If it is impracticable (see 2.8.4) to determine the period-specific effects for one or more prior periods presented, the entity should restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable.

IAS 8.45 If it is impracticable (see 2.8.4) to determine the cumulative effect at the beginning of the current period of an error on a prior period, the entity should restate the comparative information to correct the error prospectively from the earliest date practicable.

Correction of the fundamental error – allowed alternative treatment#

In accordance with the allowed alternative treatment the full adjustment to correct the fundamental error is recognised in the current period.

	2004	*2003*
Extract from income statement		
Revenue	6,000	4,000
Operating expenses	(5,550)	(3,600)
Correction of an error	(350)	-
Net profit	100	400
Extract from statement of changes in equity		
Opening retained earnings	14,400	14,000
Current year net profit	100	400
Closing retained earnings	14,500	14,400

IAS 1.86, 8.40 (1993) In our view, the effect on the income statement of the correction of the fundamental error may need to be highlighted in that statement; the presentation or disclosure of additional line items is discussed further in 4.1. However, the correction cannot be classified as an extraordinary item (see 4.8). In any event, disclosure in the notes to the financial statements of the correction will include a description of the nature of the fundamental error and the amount.

In this example only 350 of the total error of 400 is shown in the line item relating to the correction of the error; this is on the basis that the current period's results have not yet been published (notwithstanding the fact that interim reports may have been issued), so the expense of 50 relating to 2004 should be accounted for in the normal way.

IAS 8.38, 8.A (1993) If the entity uses the allowed alternative treatment, it should disclose *pro forma* information following the benchmark treatment when practicable. In our view, it is preferable for this *pro forma* information to be disclosed alongside the information prepared according to the allowed alternative treatment, rather than be disclosed only in the notes to the financial statements.

Forthcoming requirements

IAS 8 The revised standard removes the allowed alternative of recognising the cumulative effect in the current period. All errors are corrected as prior period adjustments.

2.8.3 Changes in accounting policy

IAS 8.14 A change in accounting policy should be made when required to adopt a new or revised standard or interpretation, or otherwise if a voluntary change will result in a more appropriate presentation. In applying a standard that contains both a benchmark and an allowed alternative treatment, in our view, an entity may change its accounting policy from the benchmark to the allowed alternative since both methods are considered acceptable in presenting a true and fair view. For example, in applying

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IAS 31 we believe that an entity could change its accounting policy in respect of jointly controlled entities to equity accounting from proportionate consolidation (see 3.5).

IAS 40.31 However, IFRSs provide specifically that in respect of investment property (see 3.4) it is "highly unlikely" that a change in accounting policy from a fair value to a cost basis would result in a more appropriate presentation in the financial statements.

IAS 8.17 The following changes in accounting policy are subject to special requirements:

- Changes in accounting policy that arise upon the first-time adoption of IFRSs are the subject of IFRS 1 (see 6.1).
- A change in accounting policy to revalue items of property, plant and equipment (see 3.2) or intangible assets (see 3.3) is accounted for as a revaluation in accordance with the relevant standards.

In addition, individual standards may contain specific requirements for accounting policy changes that result from their adoption (see below).

IAS 8.16 Neither the adoption of an accounting policy for new transactions or events, nor the application of an accounting policy to previously immaterial items, is a change in accounting policy. When a functional (measurement) currency becomes hyperinflationary and the restatement requirements of IAS 29 are applied (see 2.4), in our view, this is not a change in accounting policy because IAS 29 could not have been applied prior to the functional (measurement) currency being judged hyperinflationary, which is similar to accounting for a new transaction or event. This is notwithstanding the fact that purchasing power adjustments must be computed from the date that non-monetary assets (liabilities) are acquired (incurred).

The consistency of accounting policies within an entity and in the consolidated financial statements is discussed in 2.4.

IAS 8.28, 29 Disclosures required in respect of changes in accounting policy include the reasons for the change and the amount of the adjustment for the current period and for each period presented. In our view, such disclosures should be made separately for each such change.

Accounting policy change upon adoption of a new standard or interpretation

IAS 8.19 When a change in accounting policy arises from the adoption of a new or revised standard or interpretation, an entity should follow the specific transitional requirements in that standard or interpretation, which takes precedence over the benchmark and allowed alternative treatments in IAS 8.

For example, IAS 36 *Impairment of Assets* required prospective application in respect of the recognition of impairment losses, while IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* required retrospective application except that the restatement of comparatives was encouraged rather than being required. Where there are no special transitional requirements in the standard or interpretation, the entity should follow the general requirements of IAS 8#.

Forthcoming requirements

IAS 8 The allowed alternative of recognising the cumulative effect of changes in accounting policy in the current period has been removed under the revised standard.

IAS 8.28, 29 When an entity follows the specific transitional requirements of a standard or interpretation, in our view, it nonetheless should comply with the disclosure requirements of IAS 8 in respect of a change in accounting policy to the extent that the transitional requirements do not include disclosure requirements. Even though it could be argued that the disclosures are not required because they are set out in the requirements for *voluntary* changes in accounting policy, we believe that they are necessary in order to give a fair presentation.

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Benchmark treatment#

IAS 8.22, 23 Under the benchmark treatment for a change in accounting policy the effect of the change including any effect on current and deferred tax effect (see 4.7 and 3.12) is calculated retrospectively, and the opening balance of retained earnings is restated. In addition, comparatives are restated when practicable (see 2.8.4). If comparatives are restated, the opening balance of retained earnings of the earliest period presented will be adjusted; if comparatives are not restated, the opening balance of retained earnings of the current period will be adjusted. The following example illustrates the restatement.

Forthcoming requirements

IAS 8.22 Generally, an entity must apply changes in accounting policy retrospectively (i.e., as if the new accounting policy always had been applied). This is done by adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented.

IAS 41.59 At the start of 2003 entity B adopts IAS 41. The standard has no specific transitional requirements and requires any resulting change in accounting policy to be accounted for in accordance with IAS 8.

The effect of the change is an increase of 100 to the carrying amount of biological assets at the end of 2001, a gain of 30 that relates to 2002 and a gain of 40 that relates to 2003. This example is simplified and assumes no disposal of biological assets during 2002 or 2003; any impact on current and deferred tax has been ignored (see 4.7 and 3.12). Biological assets are discussed in more detail in 3.8.

Extract from draft 2003 financial statements before change in accounting policy

	Draft 2003	*2002*
Extract from income statement		
Revenue	6,000	4,000
Expenses	(5,500)	(3,600)
Net profit	500	400
Extract from statement of changes in equity		
Opening retained earnings	14,400	14,000
Current year net profit	500	400
Closing retained earnings	14,900	14,400

Comparatives restated

	2003	*2002 Restated*
Extract from income statement		
Revenue	6,040	4,030
Expenses	(5,500)	(3,600)
Net profit	540	430
Extract from statement of changes in equity		
Opening retained earnings as reported previously	14,400	14,000
Effect of change in accounting policy (note reference)	130	100
Opening retained earnings restated	14,530	14,100
Current year net profit	540	430
Closing retained earnings	15,070	14,530

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In this example the income statement is simplified and shows only revenue and expenses. The presentation of gains and losses relating to agricultural activities is discussed in 3.8.

IAS 8.16

Similar to the correction of fundamental errors, in our view, the restated comparative financial statements should have the heading "restated". In our view, this is necessary in order to highlight users to the fact that the comparative financial statements are not the same as the financial statements published previously.

IAS 8.22, 23, 26, 28, 29

As noted above, the financial statements will include disclosure regarding the change in accounting policy. In addition, any other information in respect of prior periods (e.g., historical summaries) also is restated. However, in our view, an inability to restate all of the periods presented in the historical summaries or other prior period information is not a reason to conclude that none of the comparative information required by IFRSs must be restated.

Comparatives not restated

In following the benchmark treatment for a change in accounting policy, comparatives are restated unless it is impracticable to do so (see 2.8.4). In this example, such a situation could arise if B determines the fair value of its biological assets at 1 January 2003 in preparation for the adoption of IAS 41, but does not know how much of that change is attributable to 2002 and how much is attributable to prior periods.

IAS 8.24

When comparatives are not restated the entire effect of the change is adjusted against opening retained earnings at the start of the current period.

	2003	*2002*
Extract from income statement		
Revenue	6,040	4,000
Expenses	(5,500)	(3,600)
Net profit	540	400
Extract from statement of changes in equity		
Opening retained earnings as reported previously	14,400	14,000
Effect of change in accounting policy (note reference)	130	-
Opening retained earnings restated	14,530	14,000
Current year net profit	540	400
Closing retained earnings	15,070	14,400

Allowed alternative treatment#

IAS 8.54 (1993)

Under the allowed treatment for a change in accounting policy the effect of the change is calculated retrospectively, but the cumulative adjustment is recognised in the current period.

	2003	*2002*
Extract from income statement		
Revenue	6,040	4,000
Expenses	(5,500)	(3,600)
Effect of change in accounting policy	130	-
Net profit	670	400
Extract from statement of changes in equity		
Opening retained earnings as reported previously	14,400	14,000
Current year net profit	670	400
Closing retained earnings	15,070	14,400

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IAS 1.86

In our view, if the effect of the adoption of IAS 41 is material and the allowed alternative treatment is used, the effect of the change should be disclosed as a separate line item (before tax) in the income statement; this is discussed further in 4.1. The effect of the change could not be classified as an extraordinary item (see 4.8)#.

Forthcoming requirements

IAS 1

Disclosure of items of income and expense as 'extraordinary items' in the income statement and the notes is prohibited under the revised standard.

In this example only 130 of the total adjustment of 170 is shown in the line item relating to the change in accounting policy; this is on the basis that the current period's results have not yet been published (notwithstanding the fact that interim reports may have been issued), so the gain of 40 relating to 2003 should be accounted for in the normal way.

IAS 8.54 (1993), 8.A (1993)

If the entity uses the allowed alternative and recognises the adjustment in the current period, it should disclose *pro forma* information following the benchmark treatment when practicable. In our view, it is preferable for this *pro forma* information to be disclosed alongside the information prepared according to the allowed alternative treatment, rather than being disclosed only in the notes to the financial statements.

Forthcoming requirements

IAS 8

The revised standard removes the allowed alternative of recognising the cumulative effect in the current period.

2.8.4 Impracticability of retrospective application

IAS 8.49 (1993)

A policy of retrospective application is applied consistently to all changes unless the adjustment of the opening balance of retained earnings is not reasonably determinable. Restatement of comparatives is required unless impracticable#.

Forthcoming requirements

IAS 8

The revised standard requires retrospective restatement of material errors (see 2.8.2) and retrospective application of changes in accounting policies (see 2.8.3) unless impracticable. Guidance is given on when restatement will be impracticable.

IAS 8.52

Retrospective application or restatement should be done using only information that:

- would have been available in preparing the financial statements for that earlier period; and
- provides evidence of circumstances that existed on the date(s) that the transaction or event occurred.

Other information, for example, information that uses the benefit of hindsight, may not be used.

IAS 8.52

Retrospective application or restatement is impracticable when restatement requires significant estimates to be made that cannot distinguish information that may be used from that which may not.

2.8.5 Changes in accounting estimate

IAS 8.32, 33, 39, 40

Estimates are an essential part of financial reporting, and changes therein are accounted for in the income statement in the period in which the change occurs. For example, a change in the estimate of recoverable receivables is accounted for in the period in which the change in estimate is made. Disclosures of the nature and amount of such changes may be required (see 4.1).

IAS 8.35

In some cases it can be difficult to determine whether a change represents a change in accounting policy or a change in estimate. In such cases the change is treated as a change in estimate and appropriate disclosure is given. In our view, when an entity changes its method of measuring the

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cost of inventory (see 3.7), for example, from FIFO to weighted average, this is a change in accounting policy notwithstanding the fact that both methods measure cost.

IAS 16.51, 61, 38.104 A change in the estimate of the useful life or method of recognising the depreciation / amortisation of property, plant and equipment (see 3.2) or an intangible asset (see 3.3) is accounted for prospectively as a change in estimate by adjusting depreciation / amortisation in the current and future periods.

For example, entity C acquired a printing machine at the beginning of 1997 and its useful life was estimated to be 10 years. At the end of 2003 the carrying amount of the machine is 240. At the beginning of 2004 C revises the estimated useful life downwards to a further two years from that date. Therefore, the carrying amount of 240 should be depreciated over the next two years. In addition, the decrease in useful life may indicate that the carrying amount of the machine is impaired (see 3.9).

IAS 8.34, 48 A change in estimate is different from the correction of an error because an error results from the misapplication of policy or misinterpretation of existing facts and circumstances. An estimate takes into account all existing facts and circumstances, but changes over time as those facts and circumstances change. If an objective determination cannot be made of whether a change is a change in estimate or the correction of an error, in our view, it should be accounted for as a change in estimate; this is consistent with the approach taken to distinguishing between changes in estimates and changes in accounting policy.

2.8.6 Change in classification or presentation

IAS 1.27, 38, 39 In some cases it may be appropriate to change the classification or presentation of items in the financial statements even though there has been no change in accounting policy in order to achieve a more appropriate presentation. In such cases the comparatives are restated unless impracticable, and appropriate explanatory disclosures are included in the financial statements.

IAS 19.118 For example, in 2003 entity D classified its entire obligation for post-employment benefits as non-current as allowed by IAS 19. In 2004 D decides to split the obligation into current and non-current components in the balance sheet. The 2003 comparatives should be restated if D has the information necessary to do so.

In this case we do not believe that it is necessary to head up the comparative financial statements as "restated" as the change in classification or presentation is limited and does not result in a change to either the results or total equity of the comparative period. Where the effect of a reclassification is more significant, such a heading may be necessary.

2.8.7 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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2.9 Events after the balance sheet date

(IAS 1, IAS 10)

Overview

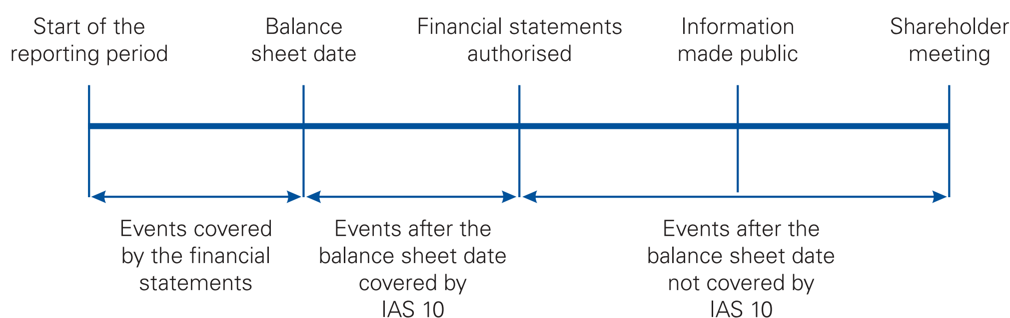
- **The financial statements are adjusted to reflect events that occur after the balance sheet date if those events provide evidence of conditions that existed at the balance sheet date.**
- **Generally, financial statements are not adjusted for events that are indicative of conditions that arose after the balance sheet date.**
- **Dividends declared, proposed or approved after the balance sheet date are not recognised as a liability in the financial statements.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 1 *Presentation of Financial Statements* and IAS 10 *Events After the Balance Sheet Date*. The revised standards are effective for accounting periods beginning on or after 1 January 2005. Early adoption is encouraged. Where an existing requirement is discussed that will be changed by the revised standard it is marked with a # and the impact of the changes are explained in the accompanying boxed text.

2.9.1 Overall approach

IAS 10.3 The following diagram illustrates the scope of IAS 10, which deals with events that occur after the balance sheet date, but before the financial statements are authorised for issue.



IAS 10.17 IAS 10 requires disclosure in the financial statements of the date that the financial statements were authorised for issue (and who gave such authorisation) in order to inform users of the date to which events have been considered.

2.9.2 Adjusting events

IAS 10.3, 8 The financial statements are adjusted to reflect events that occur after the balance sheet date, but before the financial statements are authorised for issue, if they provide evidence of conditions that existed at the balance sheet date (adjusting events).

For example, entity A is being sued for breach of contract. At the balance sheet date A asserted that it had not breached the contract and had legal opinions supporting this as the most likely outcome. Therefore, A had not recognised any provision in its draft financial statements (see 3.11 and 3.13). Prior to the financial statements being authorised by the directors, the judge in the case delivered a preliminary ruling that A was guilty and liable for damages of 1,000. A final judgement was made after the financial statements had been authorised for issue. In our view, the financial statements should be adjusted and a provision of 1,000 recognised because the preliminary ruling provides sufficient evidence that an obligation existed at the balance sheet date (in the absence of any evidence to the contrary), notwithstanding the fact that a final judgement had not yet been reached.

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2.9.3 Non-adjusting events

IAS 10.3, 10, 14,

Financial statement amounts should not be adjusted for non-adjusting events. Non-adjusting events are events that are a result of conditions that arose after the balance sheet date. An exception is when post-balance sheet events indicate that the financial statements should not be prepared on a going concern basis.

IAS 10.12

Dividends declared, proposed or approved by shareholders (when shareholder approval is required) after the balance sheet date are non-adjusting events that are not recognised as a liability in the financial statements; however, they may be reported as an appropriation of equity (see 3.10)#. The timing of the recognition of dividends is discussed further in 3.10.

Forthcoming requirements

IAS 10.12, 13

The revised standard clarifies that if an entity declares dividends after the balance sheet date the entity should not recognise those dividends as a liability at the balance sheet date. Such dividends should be disclosed in the notes to the financial statements.

IAS 10.21, IFRS 3.66, 67, 71

The following is disclosed in respect of significant non-adjusting events: the nature of the event and an estimate of its financial effect, or a statement that an estimate cannot be made. A non-adjusting event is considered to be significant when it is of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. In all cases details of a business combination effected after the balance sheet date must be disclosed.

2.9.4 Classification of accelerated debt

Generally, the classification of long-term debt as current or non-current reflects the resolution of breaches of covenants and instances of default if those resolutions occur before the financial statements are authorised for issue (see 3.1)#.

Forthcoming requirements

IAS 1.63-67

Under revised IAS 10 the classification of long-term debt as current or non-current reflects circumstances as at the balance sheet date. Post-balance sheet refinancings, amendments, waivers, etc. are not considered in determining the classification of debt. However, if an entity expects, and has the discretion, at the balance sheet date to refinance or to reschedule payments on a long-term basis the debt is classified as non-current (see 3.1).

2.9.5 Earnings per share

IAS 33.64

Earnings per share is restated to include the effect on the number of shares of certain share transactions that occur after the balance sheet date even though the transactions themselves are non-adjusting events (see 5.3).

2.9.6 Identifying the key event

In some cases an event after the balance sheet date actually may have been triggered by an event that occurred prior to the balance sheet date. In such cases it is necessary to determine the underlying causes of the event and their timing in order to determine the appropriate accounting.

IAS 10.9

For example, entity B receives notice after the balance sheet date that one of its major customers has gone into liquidation. In this case the standard states that the bankruptcy of a customer after the balance sheet date usually confirms that a loss existed at the balance sheet date. Therefore, the entity should assume that the bankruptcy is an adjusting event unless evidence to the contrary exists (e.g., the customer became bankrupt because its main operating plant was destroyed in a fire that occurred after the balance sheet date).

In other cases multiple events may occur, some before and some after the balance sheet date, and it is necessary to determine which of the events should trigger the recognition of the event in the financial statements.

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2.9.7 Future developments

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3. Specific balance sheet items

3.1 General

(IAS 1, IAS 32)

Overview

- **The balance sheet is classified either as current and non-current, or based on the broad order of liquidity of assets and liabilities#.**
- **A long-term interest-bearing liability that is due to be settled within 12 months of the balance sheet date is classified as non-current if there is an intention and supporting agreement (including a post-balance sheet date agreement) to refinance on a long-term basis#.**
- **A liability that is payable on demand following a breach of agreement is classified as non-current if the lender has agreed not to demand repayment (including via a post-balance sheet date agreement) and a further breach within 12 months of the balance sheet date is not probable#.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements* and IAS 27 *Consolidated and Separate Financial Statements*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular:

- an unclassified balance sheet presentation based on the order of liquidity is acceptable only when it provides more reliable and relevant information;
- a current liability is not be classified as non-current on the basis of an agreement to refinance that was reached after the balance sheet date; and
- a liability that is payable on demand because certain conditions are breached, should be classified as current even if the lender has agreed, after the balance sheet date but before the financial statements are authorised for issue, not to demand repayment as a result of the breach.

3.1.1 Format of the balance sheet

IAS 1.53 (1997), 71

While IFRSs require certain items to be presented on the face of the balance sheet, there is no prescribed format other than a general requirement to present the balance sheet either by distinguishing current from non-current assets and liabilities (a classified balance sheet), or broadly in order of liquidity#. In our view, presentation of a classified balance sheet is preferable.

Forthcoming requirements

IAS 1.51

The revised standard generally will require balance sheets to be presented distinguishing current from non-current assets and liabilities (a classified balance sheet). However, entities may present assets and liabilities broadly in order of liquidity when such a presentation provides information that is reliable and more relevant.

Once an entity has decided whether to present a classified balance sheet, or follow a liquidity-based approach, that format must be used in presenting both assets and liabilities within the balance sheet (i.e., an entity cannot present a mixed format balance sheet)#.

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Forthcoming requirements

IAS 1.55 The revised standard permits an entity to present some of its assets and liabilities using a current / non-current classification and others in order of liquidity if such a mixed presentation is reliable and is more relevant.

IAS 1.68, 69 The face of the balance sheet should include line items, headings and sub-totals in addition to the minimum items specified when required by an IFRS or when relevant to an understanding of the entity's financial position. Additional items may be presented because of their size or nature or to distinguish them from other items with differing timing (or liquidity) or function within the entity. For example, an entity with significant trademarks may decide to present these separately on the face of the balance sheet, rather than including them with other intangible assets.

3.1.2 Current versus non-current

Assets

IAS 1.57 (1997) Current assets are those assets that are either:

- expected to be realised in, or held for sale or consumption in, the normal course of the entity's operating cycle; or
- held primarily for trading purposes or for the short-term and are expected to be realised within 12 months of the balance sheet date#.

For example, an entity constructs office buildings for third parties; often construction takes two to three years to complete. The entity's construction work-in-progress would be classified as a current asset.

IAS 1.52 When a line item in the balance sheet includes a combination of assets that will be realised both before and after 12 months of the balance sheet date, an entity must disclose the amount expected to be realised after more than 12 months. For example, all trade receivables would be classified as current assets, but an entity would disclose in the notes the amount expected to be received more than 12 months after the balance sheet date.

IAS 1.57 All assets that do not meet the definition of current assets are classified as non-current.

IAS 1.57 Restricted cash always is classified as a non-current asset#.

Forthcoming requirements

IAS 1.57 The revised standard modified slightly the criteria for classification of items as current assets. Under the revised standard current assets are those assets that are:

- expected to be realised in, or are held for sale or consumption in, the normal course of the entity's operating cycle;
- held primarily for trading purposes;
- expected to be realised within 12 months of the balance sheet date; or
- cash or a cash equivalent (see 2.3) unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the balance sheet date.

IFRS 5.3 A non-current asset is not reclassified as current unless it is classified as held for sale under IFRS 5 (see 5.4A).

The revised standard requires the current portion of a non-current financial asset to be classified as a current asset.

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Liabilities

IAS 1.60 (1997)

Similar to current assets, current liabilities are those liabilities that are either:

- expected to be settled in the normal course of the entity's operating cycle; or
- due to be settled within 12 months of the balance sheet date#.

IAS 1.61, 62

Debt usually must be classified as current or non-current if the balance sheet distinguishes between current and non-current items based on whether it is due within one year or not. However, when some liabilities (e.g., trade payables or accruals for employees) are part of the working capital used in the entity's operating cycle, they should be classified as current liabilities even if they are due to be settled more than 12 months after the balance sheet date.

IAS 1.62

When an entity presents a classified balance sheet and has a long-term interest-bearing liability that comprises a portion due within 12 months of the balance sheet date and a portion due in later periods, the liability is split into its current and non-current components.

IAS 1.52

As in the case of assets, when a line item in the balance sheet includes a combination of liabilities that are expected to be settled both before and after 12 months of the balance sheet date, an entity must disclose the amount expected to be settled after more than 12 months.

Forthcoming requirements

IAS 1.60

The revised standard modifies slightly the criteria for classification of an item as a current liability. Under the revised standard current liabilities are those liabilities that are:

- expected to be settled in the normal course of the entity's operating cycle;
- held primarily for trading purposes;
- due to be settled within 12 months of the balance sheet date; or
- not subject to an unconditional right of the entity to defer settlement of the liability for at least 12 months after the balance sheet date.

IAS 1.63, 64 (1997)

A long-term interest-bearing liability that is due to be settled within 12 months of the balance sheet date should be classified as non-current if there is an intention and supporting agreement to refinance on a long-term basis, which may be evidenced by a post-balance sheet date agreement to refinance#. However, if the original term of the financing was for less than 12 months, in this case the agreement to refinance must be reached before the balance sheet date.

Forthcoming requirements

IAS 1.63, 64

The revised standard requires the current portion of long-term debt to be classified as current even if an agreement to refinance or reschedule payments on a long-term basis is completed after the balance sheet date but before the financial statements are authorised for issue. However, if an entity expects and is able, solely at its own discretion, to refinance or roll over an obligation for at least 12 months after the balance sheet date under an existing loan facility, it should classify the obligation as non-current even if the loan otherwise would be due within a shorter period.

IAS 1.65 (1997)

A liability that is payable on demand because loan conditions have been breached is classified as non-current if the lender has agreed not to demand repayment as a result of the breach, and a further breach within 12 months of the balance sheet date is not probable. This includes an agreement reached after the balance sheet date#.

Forthcoming requirements

IAS 1.65

The revised standard requires a liability that is payable on demand because loan conditions are breached to be classified as current even if the lender has agreed, after the balance sheet date but before the financial statements are authorised for issue, not to demand repayment as a result of the breach.

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3.1.3 Offsetting

IAS 32.42 A financial asset and a financial liability should be offset and reported net only when the entity has a legally enforceable right to offset, and it intends either to settle on a net basis or to settle both amounts simultaneously (see 5.6).

Specific offsetting rules exist for deferred tax assets and liabilities and plan assets and obligations in a defined benefit plan (see 3.12 for the specific application of these requirements in the case of deferred tax, and 4.4 for plan assets in a defined benefit plan).

Non-financial assets and liabilities cannot be offset under IFRSs.

3.1.4 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

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3.2 Property, plant and equipment

(IAS 16, SIC–6, SIC–14, SIC–23)

Overview

- **Property, plant and equipment is recognised initially at cost.**
- **Cost includes all expenditure, including administrative and general overhead expenditure, directly attributable to bringing the asset to a working condition for its intended use#.**
- **Cost includes the estimated cost of dismantling and removing the asset and restoring the site#.**
- **Cost may include certain interest costs.**
- **Property, plant and equipment is depreciated over its useful life.**
- **A change in useful life is accounted for prospectively as a change in accounting estimate.**
- **When an item of property, plant and equipment comprises individual components for which different depreciation methods or rates are appropriate, each component is accounted for separately.**
- **Subsequent expenditure is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset, or when it replaces a component that is accounted for separately#.**
- **Property, plant and equipment may be revalued to fair value if all items in the same class are revalued at the same time and the revaluations are kept up to date.**
- **Compensation for loss or impairment cannot be offset against the carrying amount of the asset lost or impaired.**
- **The gain or loss on disposal is the difference between the net proceeds received and the carrying amount of the asset.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 16 *Property, Plant and Equipment*. The revised standard incorporates the requirements of SIC–6 *Costs of Modifying Existing Software* and SIC–14 *Property, Plant and Equipment – Compensation for the Impairment or Loss of Items* and SIC–23 *Property, Plant and Equipment – Major Inspection or Overhaul Costs*. It is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. In March 2004, the IASB issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. It is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged subject to additional criteria. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standard:

- clarifies that a component approach applies (i.e., an entity should consider whether an item of property, plant and equipment is a combination of separate parts with different useful lives or consumption patterns). Each identified part (and any remainder) is depreciated separately;
- clarifies that an item must continue to be depreciated when it is idle. However, a non-current asset that is held for sale (either individually or as part of a disposal group) in accordance with IFRS 5 *Non-current Assets Held for Disposal and Discontinued Operations* is not depreciated (see 5.4A);

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- changes the definition of 'residual value' to the net amount that the asset could be sold for at the balance sheet date if the asset were in the condition that it will be in when the entity intends to dispose of it;
- requires useful life, residual value and method of depreciation to be reviewed at least at each financial year-end; and
- clarifies that the cost of an item of property, plant and equipment includes not only the 'initial estimate' of the costs relating to dismantlement, removal or restoration of property, plant or equipment at the time of *installing the item* but also costs incurred during the period of the *use* for purposes other than producing inventory.

In May 2004, IFRIC issued IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. It is applicable for annual periods beginning on or after 1 September 2004 and earlier application is encouraged. The interpretation requires that changes to an existing obligation generally must be added to or deducted from the cost of the related asset and depreciated prospectively over the asset's remaining useful life.

3.2.1 Definition

IAS 16.6 Property, plant and equipment comprises tangible assets held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes, that are expected to be used for more than one period.

IAS 16.8 Spare parts, stand-by and servicing equipment held by an entity are classified as property, plant and equipment if they are expected to be used for more than one period; if not, they are classified as inventories (see 3.7).

A long-term leasehold interest in a property must be accounted for as a lease in accordance with IAS 17 (see 5.1) unless it is classified as an investment property. Any large payment made to acquire a leasehold interest is classified as a lease prepayment (assuming that the lease is an operating lease) rather than as property, plant and equipment.

IAS 40.2 In the case of investment property the requirements of IAS 40 will apply (see 3.4)#.

Forthcoming requirements

IAS 17.2 The revisions to IAS 17 permit a lessee to classify certain operating leases as investment property (see 3.4).

3.2.2 Initial recognition

IAS 16.15 Property, plant and equipment is recognised initially at cost.

Directly attributable

IAS 16.16, 17, 19, 20 Cost includes all expenditure, including administrative and general overhead expenditure, directly attributable to bringing the asset to a working condition for its intended use#. The cost of an item of property, plant and equipment includes the cost of its dismantlement, removal or restoration. As noted in 4.6, interest also may be capitalised as part of the cost in some instances.

Forthcoming requirements

IAS 16.16(c) The revised standard clarifies that the cost of an item of property, plant and equipment includes not only the 'initial estimate' of the costs relating to dismantlement, removal or restoration of property, plant or equipment at the time of *installing the item* but also during the period of the *use* for purposes other than producing inventory (e.g., changes in the original estimate of dismantlement, removal or restoration costs).

IAS 16.16(b) The revised standard clarifies 'intended use' as being capable of operating in the manner intended by management.

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IAS 16.17(a) The revised standard clarifies that costs of employee benefits as defined by IAS 19 that are incurred for employees working directly on the construction or acquisition of the item of property, plant and equipment are directly attributable costs of that item.

The costs incurred need not be external or incremental. For example, entity A is installing a major piece of equipment at one of its factories. One of A's existing engineers is assigned to manage the installation on a full-time basis; installation is expected to take six weeks. In our view, the cost of the engineer's salary, including all employee benefits, during the period of installation should be included in the cost of the plant even though his or her salary would have been incurred in any event#.

In some cases an entity will incur expenditure in carrying out a feasibility study prior to deciding whether to invest in an asset or in deciding which asset to acquire. In our view, expenses incurred for feasibility assessment should be expensed as incurred because they are not linked to a specific item of property, plant and equipment. This is consistent with the approach taken under IFRSs for the development of a Web site (see 3.3).

Often staff need to be trained in the use of a new item of property, plant and equipment. In our view, training costs should not be capitalised as part of the cost of the item since training costs are not directly attributable to bringing the asset itself into a working condition#. In addition, capitalisation of expenditure on training is prohibited by the standard on intangible assets (see 3.3). If the asset is installed by a third party and training is part of the total contract price, we believe that some part of the total price should be allocated to training and expensed as incurred.

Forthcoming requirements

IAS 16.19(c) The revised standard clarifies that the training costs are not recognised as part of the costs of an item of property, plant and equipment.

In another example, entity B plans to rent a retail store under an operating lease and will renovate the store so that it conforms with the design of its other stores. B cannot commence the renovations until it takes possession of the store. An issue arises as to whether B may capitalise the rental expense incurred during the renovation period. Our preference is for the lease payments to be expensed as incurred on the basis that they are a pre-operating expense that is not required to bring the asset to its working condition#.

Forthcoming requirements

IAS 16.19(a) The revised standard clarifies that the costs of opening a new facility are not part of the costs of an item of property, plant and equipment.

IAS 16.20(b) The revised standard clarifies that the initial operating losses such as those incurred while demand for the item's output builds up are not part of the costs of an item of property, plant and equipment.

In a slightly different example, entity C has owned a site for a number of years and decides to renovate it. C could still operate from the site while the renovation is ongoing, but in order to carry out the renovation more efficiently, C rents an alternative site for the period of the renovation. In our view, the rental expense in respect of the temporary site incurred during the renovation cannot be capitalised as part of the cost because the completion of the renovation is not dependent upon that cost being incurred.

An entity may purchase land with the intention of constructing a new building on the site. In our view, the cost of demolishing any existing building on the site should be capitalised as part of the cost of the property. However, it is not clear whether the cost should be capitalised to the cost of the land or to the cost of the building; this distinction is important because land and buildings generally are

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depreciated differently (see below). In our view, the amount should be capitalised to the cost of the building because the demolition is a direct result of the decision to construct a new building.

A similar, but less common, example is when an entity relocates a community (or part thereof) in order to construct its asset. For example, entity D plans to construct a golf course on a site occupied currently by a small town. D agrees to pay the cost of relocating the residents to another site. In our view, the relocation costs should be capitalised as they are directly attributable to the construction of the golf course.

While it is common for the design of a complex asset to be modified and improved during construction, care should be taken to avoid double-counting costs. For example, entity E is constructing a hotel; the cost of designing the hotel has been capitalised as part of the cost of the asset. Half way through construction, the directors of E reassess their plans and decide that a hotel no longer is viable in the current economic environment. Instead, the directors decide to develop the site into a retirement village, which requires a complete redesign of the site. In our view, although it is appropriate to capitalise the cost of designing the retirement village, the original hotel design costs should be written off since they are not part of the eventual asset. A similar approach should be adopted for any other costs (e.g., construction costs) that do not form part of the eventual asset because of changes made in the course of construction.

Abnormal waste

IAS 16.22 Similar to determining the cost of inventory (see 3.7), when an item of property, plant and equipment is constructed by an entity, the standard requires abnormal amounts of wasted material, labour and other resources to be expensed as incurred instead of being capitalised. A determination of what should be considered "abnormal" is subjective, but in our view, the factors to consider include the level of technical difficulty involved with the construction, the scale of the project, the estimates and timelines included in the project planning, and the usual construction process for that type of asset.

For example, entity F is constructing a plant that produces plastic building blocks for children. During the commissioning phase, which should take two weeks, sample building blocks are produced to ensure that the plant is operating correctly; the engineers use the test results to finalise the calibration of the machines. Most of the building blocks produced during testing are unfit for sale and are disposed of. The commissioning phase lasts two weeks as scheduled. In this example the costs incurred as part of the testing are a normal part of the construction process, and the related costs should be capitalised.

Continuing the above example, if commissioning was due to take two weeks, but actually took four weeks (e.g., because a trainee engineer had installed a machine incorrectly or because site management forgot to schedule machine operators for the testing phase), in our view, any additional costs incurred as a result of such events should be considered abnormal and expensed as incurred. The additional costs could be measured by reference to the amount of testing that was planned.

Staying with the same example, if testing took four weeks instead of two because F was introducing a new and previously untested technology into its production process and unforeseen technical difficulties were experienced, in our view, the additional costs incurred should be capitalised because the costs are not "abnormal".

IAS 16.22 Abnormal waste is discussed in the context of assets that are constructed by the entity. In our view, these principles apply equally when the asset is not constructed by the entity, but where the installation process nonetheless is necessary to bring the asset to its working condition.

Pre-operating costs and losses

IAS 16.19 Start-up and pre-operating costs cannot be capitalised as part of the cost of property, plant and equipment unless those costs are necessary to bring the asset to its working condition. For example,

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entity G is opening a new plant in a town where it has not operated previously. In addition to obtaining a certificate to confirm that the plant meets environmental specifications, G is required to obtain general permits that allow it to conduct business in the town. In our view, the cost of these permits cannot be capitalised because they are general business costs that do not relate specifically to the asset.

IAS 16.20 An entity may incur losses prior to the asset reaching its planned performance level; such losses cannot be capitalised. Continuing the example of F and its building blocks, after installation F runs the new plant at half capacity for a month while staff are trained in how to use it correctly. As a result F incurs an operating loss during that month. The loss should be recognised in the income statement.

Interruptions

IAS 23.24 In some cases construction will not be continuous and interruptions will occur during which time costs still may be incurred. For example, the entity may have to continue paying site insurance costs. IAS 16 is silent as to whether such costs may be capitalised, but in our view, guidance should be drawn from IAS 23 and the capitalisation of borrowing costs (see 4.6).

Accordingly we believe that costs incurred during an interruption should be capitalised only if:

- the interruption is temporary and is a necessary part of getting the asset into its working condition (e.g., the construction of a bridge is suspended while water levels are high, provided that such costs are not abnormal waste – see above); or
- the costs are an integral part of getting the asset into its working condition even though physical construction has been suspended (e.g., the cost of obtaining permits for the eventual operation of the asset).

Decommissioning

IAS 16.16, 20 The cost of property, plant and equipment includes the estimated cost of dismantling and removing the asset and restoring the site to the extent that such cost is recognised as a provision (see 3.11)#.

For example, entity H constructs a chemical plant that has a useful life of 30 years. Environmental laws require H to dismantle the plant at the end of its useful life. H recognises a provision for removal costs (see 3.11), which is capitalised as part of the cost of the asset.

Forthcoming requirements

IAS 16.16(c) The revised standard clarifies that the cost of an item of property, plant and equipment includes not only the 'initial estimate' of the costs relating to dismantlement, removal or restoration of property, plant or equipment at the time of *installing the item* but also during the period of the *use* for purposes other than producing inventory. In our view, decommissioning and restoration costs incurred by the production of inventory should be capitalised as part of inventory costs.

IFRIC 1.3 Subsequent to initial recognition the amount of a decommissioning provision generally will change due to the following (see 3.11):

- changes in the estimate of the amount or timing of expenditures required to dismantle the plant;
- changes in the discount rate; and
- the unwinding of the discount.

IAS 16 discusses decommissioning in the context of the initial recognition of property, plant and equipment, but is silent on the treatment of such provisions that are recognised after the initial recognition of the asset. Continuing the above example, when H first constructs its chemical plant there are no applicable environmental laws. However, two years later the government introduces a new law requiring the plant to be dismantled at the end of its useful life. In our view, the amount of the provision should be capitalised as part of the cost of the asset. The capitalisation of these costs should not result in the carrying amount of the asset exceeding its recoverable amount (see 3.9).

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IAS 37.C The amount capitalised to the cost of property, plant and equipment excludes any portion of the provision that relates to damage caused by ongoing operations rather than to the construction of the asset#. Continuing the above example, in addition to being required to dismantle the plant at the end of its useful life, H also is required to clean up environmental damage caused by its operations. The clean-up costs cannot be capitalised.

Forthcoming requirements

IFRIC 1.5-7 IFRIC 1 provides guidance on the treatment of changes to decommissioning provisions recognised after the initial recognition of the asset. The interpretation requires the effect of any changes to an existing obligation to be added to or deducted from the cost of the related asset and depreciated prospectively over the asset's useful life. This is consistent with the accounting treatment for changes in estimates in IAS 8 (see 2.8).

This principle is applied regardless of whether the cost model or the revaluation model is applied in accounting for the item of property, plant and equipment. However, the implementation of this principle varies with the choice of model.

Cost model

Under the cost model the changes in the liability are added to or deducted from the cost of the related asset in the current period. However, the amount deducted from the cost of the asset cannot exceed its carrying amount. Any excess therefore is recognised immediately in profit or loss as an asset cannot have a negative carrying value.

An increase in the cost of an asset may require consideration of whether there is an indication of impairment. An entity should consider whether calculation of the recoverable amount under IAS 36 is necessary (see 3.9).

Revaluation model

Under the revaluation model, valuations must be kept sufficiently up to date that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. A change in the liability does not, of itself, affect the *valuation* of the asset, since the value of the liability should be excluded from the asset valuation.

The change in the liability affects the difference between the valuation and what would have been recognised under the cost model. Therefore, changes in the liability affect the revaluation surplus or deficit previously recognised on that asset as follows:

- a decrease in the liability is credited directly to the revaluation surplus in equity (except when it reverses a revaluation deficit previously recognised in profit or loss); and
- an increase in the liability is recognised in profit or loss (except when any credit balance remains in the revaluation surplus in equity).

The depreciated cost of the asset cannot be negative. For example, if the depreciated cost of an unimpaired asset is 25, and its revalued amount is 100, there is a revaluation surplus of 75. If the decommissioning liability is reduced by 30, the depreciated cost of the asset is reduced to nil, and the remaining five is recognised directly in profit or loss.

A change in the liability also may change the market's perception of the value of the asset for financial reporting purposes and an entity should consider whether a revaluation of both the impacted asset and other assets in the same asset class may be required.

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Incidental operations

IAS 16 is silent on the treatment of income earned in connection with the construction or installation of an item of property, plant and equipment#. Generally there are two types of incidental income:

- Income earned from the operation of the asset. For example, referring back to the above example of F and the building blocks produced during testing, if those building blocks could be sold as seconds rather than disposing of them, how should the resulting revenue be accounted for?
- Income incidental to the decision to construct the asset, but not generated by the asset itself. For example, entity K acquires a sports hall with the intention of constructing a supermarket on the site. While K waits to receive permits for the construction, it rents out the sports facilities to a local school.

In the absence of specific guidance, in our view an entity should make an accounting policy election in respect of each type of incidental income, which should be applied consistently, to either:

- recognise the income in the income statement, when the income meets the definition of income contained in the Framework (see 1.2); or
- deduct the income from the cost of the asset on the basis that it is an integral part of the construction or installation of the asset.

Forthcoming requirements

IAS 16.17(e) The revised standard clarifies that incidental income from testing a new asset is part of the directly attributable cost of the asset. Therefore, income earned in the above example from selling as seconds the building blocks produced when testing the asset, is deducted from the costs of testing the asset. The costs of testing the asset (less the income) are recognised as part of the cost of the item of property, plant and equipment.

IAS 16.21 The revised standard clarifies that other incidental operations should not be considered necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, income and expenses from incidental operations should be recognised in the income statement and included in their respective classification of income and expense.

Deferred payment

IAS 16.23, 39.AG64 When payment is deferred, the cost of the asset is the cash price equivalent (i.e., current cash price). This calculation is different from the calculation of the financial liability (the amount due in respect of the acquisition) that would be made under IAS 39, which would require the cash flows to be discounted using a market rate of interest (see 3.6). However, in our view, the requirements of IAS 16 should apply because the standard addresses specifically deferred payment for property, plant and equipment .

IAS 39.9, 47 The difference between the cash price equivalent and the amount payable is recognised as interest expense over the period until payment. In our view, the effective interest method should be applied in accordance with IAS 39 (see 3.6) since there is nothing to the contrary in IAS 16.

3.2.3 Depreciation

IAS 16.41, 49 (1998) Subsequent to initial recognition property, plant and equipment is depreciated on a systematic basis over its useful life, which should be reviewed periodically#.

Forthcoming requirements

IAS 16.51 The revised standard requires the useful life of an asset to be reviewed at least at each financial year-end.

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IAS 16.51 A change in the useful life is accounted for prospectively as a change in accounting estimate (see 2.8).

For example, entity L acquired a printing machine at the beginning of 1996 and its useful life was estimated to be 10 years. At the end of 2003 the carrying amount of the machine is 240. At the beginning of 2004 L revises the estimated useful life downwards to a further two years from that date. Therefore, the carrying amount of 240 should be depreciated over the next two years. In addition, the decrease in useful life may indicate that the carrying amount of the machine is impaired (see 3.9).

IAS 16.6, 50, 60 The purpose of depreciation is not the recognition of decreases in the value of property, plant and equipment; rather, the purpose is to allocate the cost or revalued amount of an asset over its useful life on a systematic basis. Therefore, depreciation must be recognised even if the value of the asset (e.g., a hotel) is being maintained by regular repair and maintenance.

IAS 16.48 The depreciation charge for each period is recognised as an expense in the income statement (unless it is included in the carrying amount of another asset).

Residual value

IAS 16.6, (1998) 53 An asset's depreciable amount is its cost less its residual value. Residual value is the net amount that the entity expects to obtain for the asset *at the end of its useful life* after deducting the expected costs of disposal#. The estimated residual value is based on similar assets that have reached the end of their useful lives at the date that the estimate is made. In many cases the residual value will be zero because the asset will be scrapped at the end of its useful life.

For example, entity M buys a machine costing 400. M plans to use the machine for three years before selling it on the second-hand market. At the date of acquisition similar machines that are three years old are traded for 150 on the second-hand market. The residual value is therefore 150 and accordingly the depreciable amount is 250.

Forthcoming requirements

IAS 16.6, 53 The revised standard changes the definition of 'residual value' to the amount that an entity could receive for the asset *at the balance sheet date* if the asset were in the condition as it will be when the entity expects to dispose of it. This change clarifies that the residual value does not include expected future inflation.

IAS 16.46 (1998) Subsequent to initial recognition of an asset, residual values are not changed for increases in prices unless the asset is revalued, in which case a new estimate of the residual value is made#. This is consistent with the purpose of depreciation being to allocate cost rather than to measure decreases in value.

Forthcoming requirements

IAS 16.51 The revised standard requires the residual value of an asset to be reviewed at least at each financial year-end and the changes in the residual value are accounted as a change in an accounting estimate in accordance with IAS 8 (see 2.8).

IAS 16.54 If the residual value of an asset increases to an amount equal to or more than the asset's carrying amount, the asset's depreciation charge will be zero. The entity would resume charging depreciation when the residual value falls below the asset's carrying amount.

Methods of depreciation

IAS 16.60, 16.52 (1998) The method of depreciation should reflect the pattern in which the benefits associated with the asset are consumed, and should be reviewed periodically#.

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Forthcoming requirements

IAS 16.61 The revised standard requires the depreciation method applied to an asset to be reviewed at least at each financial year-end.

IAS 16.61 A change in the depreciation method is accounted for prospectively as a change in accounting estimate (see 2.8).

IAS 16.62 IAS 16 does not require a specific method of depreciation to be used, and mentions the straight-line method, the diminishing (or reducing balance) method and the sum-of-the-units (or units of production) method. Other methods of depreciation that are not mentioned in the standard include the annuity method and renewals accounting.

Straight-line

In our experience the straight-line method is used most commonly and in our view, it is the most appropriate method when the level of consumption of an asset over the years is uncertain. For example, a machine cost 150, has a residual value of 30 and a useful life of eight years.

Therefore, the annual depreciation charge is:

Yr 1	*Yr 2*	*Yr 3*	*Yr 4*	*Yr 5*	*Yr 6*	*Yr 7*	*Yr 8*
15	15	15	15	15	15	15	15

Reducing balance method

Under the reducing balance method, depreciation is measured as a percentage of the current carrying amount of the asset (i.e., less accumulated depreciation to date). Using the same example as before, the machine would be depreciated at 18.25 per cent per annum in order to reduce the carrying amount to the residual value of 30 at the end of eight years.

Therefore, the annual depreciation charge would be:

Yr 1	*Yr 2*	*Yr 3*	*Yr 4*	*Yr 5*	*Yr 6*	*Yr 7*	*Yr 8*
27	22	18	15	12	10	8	7

Using this method the depreciation charge declines over the years, which is appropriate when the machine provides greater benefits to the entity in its earlier years, for example, because it will be less capable of producing a high-quality product in later years, or because the machine will be less technologically advanced in later years.

Units of production method

Under the units of production method, depreciation is based on the actual level of output or usage expected to be achieved. While this method may provide a more accurate picture of the consumption of an asset, it may be difficult to estimate the expected output over the life of the asset.

Continuing the above example, assume that the expected output over the life of the asset is 8,600 units and that the estimated annual output is as follows:

Yr 1	*Yr 2*	*Yr 3*	*Yr 4*	*Yr 5*	*Yr 6*	*Yr 7*	*Yr 8*
1,500	1,200	1,200	1,100	1,100	1,000	1,000	500

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Therefore, the annual depreciation charge would be:

Yr 1	*Yr 2*	*Yr 3*	*Yr 4*	*Yr 5*	*Yr 6*	*Yr 7*	*Yr 8*
21	17	17	15	15	14	14	7

IAS 16.51 If this method of depreciation is used, the estimates of future production would be revised each year in accordance with the requirement to review the expected useful life periodically.

Annuity method

"Annuity depreciation" refers to depreciation methods under which the depreciation charge is adjusted to reflect the time value of money. Such depreciation methods result in lower depreciation charges in initial periods, and larger depreciation methods in later periods. These methods are used under some national accounting practices, for example, by lessors in order to recognise a level profit, after considering financing costs related to the leased asset over the lease term. In our view, the financing costs of an asset should not impact the selection of a depreciation policy. IFRSs require depreciation to reflect the consumption of the economic benefits of an asset. We believe that this does not extend to consideration of financing costs or inflation adjustments.

Renewals accounting

In some countries it has been common in certain industries (e.g., utilities) not to recognise depreciation on the basis that the assets are maintained at a certain performance or service level and all maintenance costs, including costs incurred to replace components of the asset, are expensed immediately. It has been argued that the amount recognised in the income statement in respect of the upkeep of the assets is similar to the depreciation charge that would have been recognised.

A variation on the above is condition-based depreciation whereby the condition of the asset is assessed and depreciation is measured as the increased cost required to restore the asset to a predetermined performance or service level.

In our view, these methods of depreciation are not acceptable under IFRSs unless the impact on the financial statements is immaterial.

Commencement of depreciation

IAS 16.41, 43 (1998) Although an item of property, plant and equipment is depreciated over its estimated useful life, IFRSs are not explicit about when depreciation should commence. In our view, depreciation should commence only when an item of property, plant and equipment is brought into use *except* when the economic benefits embodied in the asset are being consumed prior to the asset being brought into use#.

For example, entity N buys computer equipment that it knows will be technologically obsolete after two years. N does not bring the equipment into use until six months after the acquisition. In this case we believe that depreciation should commence when the asset is ready for use because the related economic benefits are being consumed through the passage of time.

Forthcoming requirements

IAS 16.55 The revised standard clarifies that depreciation of an asset begins when it is available for use (i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management).

In addition, when an item of property, plant and equipment is substantially complete, but is not yet in use, an entity should ensure that the asset is reviewed for potential indicators of impairment (see 3.9).

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3.2.4 Component accounting

IAS 16.43-49

When an item of property, plant and equipment comprises individual components for which different depreciation methods or rates are appropriate, each component is accounted for separately. A separate component may be either a physical component or a non-physical component that represents a major inspection or overhaul.

In our view, based on the wording of IAS 16, component accounting is compulsory when it would be applicable. However, this does not mean that an entity should split its assets into an infinite number of components if the effect on the financial statements would be immaterial#.

Forthcoming requirements

IAS 16.43

The revised standard clarifies that an item of property, plant and equipment should be separated into parts ("components"), when those parts are significant in relation to the total cost of the item.

IAS 16.46

When an entity depreciates some parts of an item of property, plant and equipment separately it depreciates the remainder of the item separately. The remainder consists of the parts of the item that are not significant individually. If an entity has varying expectations for these parts, it should use approximation techniques to estimate an appropriate depreciation pattern for the remainder to reflect the consumption pattern and / or usefulness of its parts.

Although individual components are accounted for separately, the financial statements continue to disclose a single asset. For example, an airline generally would disclose aircraft as a class of assets, rather than disclosing separate information in respect of the aircraft body, hydraulics, engines, seating etc.

Physical components

When the component is a physical component (e.g., the motor in an engine) the carrying amount of the component is determined by reference to its cost. For example, entity O constructs a sports stadium that has an overall useful life of 50 years; one of the components of the stadium is the seating, which has an expected useful life of 10 years. The cost of the stadium in total is 500, which included 50 in respect of the seating. Therefore, the seating component is measured at 50.

In many cases an entity acquires an asset for a fixed sum without knowing the cost of the individual components. In our view, the cost of individual components should be estimated either by reference to current market prices (if possible), in consultation with the seller or contractor, or using some other reasonable method of approximation.

Major inspection or overhaul costs

IAS 16.14

Major inspections and overhauls are identified and accounted for as a separate component if that component is used over more than one period.

IAS 16.13, 14

When a major inspection or overhaul cost is embedded in the cost of an item of property, plant and equipment, it is necessary to estimate the carrying amount of the component because the cost of the asset does not include any amount attributable to the inspection or overhaul. The carrying amount of the component should be determined by reference to the *current* market price of such overhauls and not the expected future price.

For example, entity P runs a merchant shipping business and has just acquired a new ship for 400. The useful life of the ship is 15 years, but it will be dry-docked every three years and a major overhaul carried out. At the date of acquisition the dry-docking costs for similar ships that are three years old is approximately 80. Therefore, the cost of the dry-docking component for accounting purposes is 80 and this amount would be depreciated over the three years to the next dry-docking. The remaining carrying amount, which may need to be split further into components, is 320. Any additional components would be depreciated over their own estimated useful lives.

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IAS 16.12 Component accounting for inspection or overhaul costs is intended to be used only for major expenditure that occurs at regular intervals over the life of an asset. Costs associated with routine repairs and maintenance should be expensed as incurred.

Costs to be included

IFRSs are silent with regard to the specific costs that should be included in measuring the component attributable to major inspection or overhaul costs (i.e., whether they must be incremental and / or external costs).

Continuing the above example of P and its ship, the current market price of a dry-docking service is 80. However, P's currently-employed technicians will carry out most of the work and the external costs incurred are likely to be only 30. In our view, the entity should attribute the entire 80 to the component on the basis that the cost of an item of property, plant and equipment includes internal as well as external costs (see 3.2.2).

Relationship with physical components

IFRSs do not address the allocation of costs to a major inspection or overhaul when the underlying asset comprises a number of physical components. For example, P's ship comprises two physical components: the ship's body (250) and the engines (150). The dry-docking will involve servicing both of these components. In reality the ship would comprise a number of other components. However, the example has been simplified for illustrative purposes.

In our view, the dry-docking component should be allocated between the ship's body and the engines on the basis of their relative costs. Therefore, the components of the ship will be:

• dry-docking costs	80	
• body	200	equals 250 - (250/400 x 80)
• engines	120	equals 150 - (150/400 x 80)

This issue arises only prior to the first major inspection or overhaul being carried out because the component cost is assumed rather than actual.

Replacing a component

IFRSs are silent on the replacement of a component prior to it being depreciated fully#. For example, P carries out the dry-docking of its ship after two years instead of three. The carrying amount of the overhaul at that date is 27 (80/3). The actual dry-docking costs are 100.

In our view, the remaining carrying amount of the component that has been replaced should be written off immediately because the component effectively has been disposed of. However, we believe that the amount written off should be included in depreciation instead of being classified as a loss on disposal because, although each component is accounted for as a separate asset, component accounting is simply a mechanism to achieve an appropriate depreciation charge in each period and in this instance the estimated useful life is being revised.

The actual dry-docking costs of 100 will be capitalised to the cost of the ship and depreciated over the expected period until the next dry-docking.

Forthcoming requirements

IAS 16.14 The revised standard clarifies that the remaining portion of the component that is replaced by a new component should be derecognised.

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3.2.5 Subsequent expenditure

IAS 16.23 (1998), SIC 6.4 (1997)

Expenditure incurred subsequent to the initial recognition of property, plant and equipment is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset, or when it replaces a component that is accounted for separately (see 3.2.4). Expenditure incurred simply to restore or maintain the level of future economic benefits is expensed as incurred (i.e., when the work is carried out).

Although the standard refers to the "originally assessed standard of performance" in practice this is interpreted as the standard of performance immediately before the expenditure being incurred#. For example, entity Q acquired a machine 10 years ago that was capable of producing 1,000 units a day. The performance of the machine has deteriorated over the years so that by the end of 2004 the machine can produce only 700 units a day; however, no impairment loss is recognised because the carrying amount does not exceed the recoverable amount (see 3.9). Q upgrades the machine so that it can produce 900 units a day. In practice the expenditure is capitalised because it increases the production from 700 to 900, even though this is still lower than the originally assessed standard of performance of 1,000.

IAS 16.26 (1998)

An item of property, plant and equipment may be acquired in a state of ruin, which was taken into account in determining the purchase price. For example, an office may need painting (for functional rather than marketing purposes). The cost of painting that is incurred subsequent to the acquisition should be capitalised because the asset's original standard of performance has been improved. This can be distinguished from the situation where the building is repainted, not because there is anything wrong with the existing paint work, but simply because the entity would prefer a different colour. In this case we believe that the cost of painting should be expensed as incurred.

Forthcoming requirements

IAS 16.7, 12

Under the revised standard, any subsequent expenditure on the asset is recognised *only* if it meets the general recognition criteria (i.e., it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably). Therefore, expenditure incurred simply to restore or maintain the level of future economic benefits is expensed as incurred.

In some cases an entity may incur costs in relocating assets. For example, entity R is moving production to a new plant in order to achieve lower operating costs. R incurs costs in moving its machines from the old plant to the new one. In our view, the cost of relocation should be expensed because the expenditure does not enhance the future economic benefits attributable to the machines#.

Forthcoming requirements

IAS 16.20

The revised standard clarifies that recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs of relocating or reorganising part or all of an entity's operations is not included in the carrying amount of an item of property, plant and equipment.

IAS 16.11

Expenditure incurred to acquire safety or environmental equipment may be capitalised as a separate item of property, plant and equipment because it enables the future economic benefits in the underlying property, plant and equipment to be realised; this is notwithstanding the fact that the expenditure itself does not give rise to future economic benefits or enhance the standard of performance of the asset.

IAS 16.11

For example, the government introduces new emissions laws that require aluminium smelters to be fitted with a new grade of filter; unless the new filters are fitted, smelters are no longer permitted to operate. The cost of the new filters is capitalised as property, plant and equipment as long as the total amount capitalised (the smelter plus the new filters) does not exceed recoverable amount (see 3.9).

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3.2.6 Revaluations

IAS 16.31-42 Property, plant and equipment may be revalued to fair value. Any surplus arising on the revaluation is recognised directly in a revaluation reserve within equity except to the extent that the surplus reverses a previous revaluation deficit on the same asset charged in the income statement, in which case the credit to that extent is recognised in the income statement. Any deficit on revaluation is charged in the income statement except to the extent that it reverses a previous revaluation surplus on the *same asset*, in which case it is taken directly to the revaluation reserve. Therefore, revaluation increases and decreases cannot be offset, even within a class of assets.

Fair value

Market value

IAS 16.32 The fair value of property, plant and equipment is its market value, which has a similar meaning to fair value. Disposal costs are not deducted in determining market value.

In addition, market value is the highest possible price that could be obtained for the item of property, plant and equipment, without regard to its existing use. For example, entity S owns offices situated in a prime residential location. The value of the property as residential real estate exceeds its value as an office building. Accordingly market value should be determined based on its value as residential real estate.

Depreciated replacement cost

IAS 16.33 Plant and equipment is valued using depreciated replacement cost (DRC) only when there is no evidence of market value. This might occur when the asset is specialised and rarely sold except as part of a continuing business. A DRC valuation considers how much it would cost to reproduce an asset after adjusting for depreciation and optimisation (i.e., it estimates the replacement cost of the required capacity of the asset). The adjustment for depreciation takes into account the age of the asset (in relation to its useful life) and its residual value. The adjustment for optimisation takes into account situations where the asset is obsolete, over-engineered or has capacity greater than that required.

For example, entity T operates a network of water pipes; the diameter of the pipes is greater than required currently, and greater than is expected to be required (even for necessary stand-by or safety purposes). The DRC valuation would be optimised to eliminate the cost of replacing the surplus capacity in T's network.

When an asset is obsolete, the DRC valuation is optimised by reducing the reproduction cost of the entity's specific asset so that it is not greater than the cost of a modern equivalent asset that provides an equivalent standard of performance or service capacity.

When an asset has surplus capacity, in our view the optimisation adjustment for the DRC valuation should consider whether the surplus capacity has an alternative use. When there is no alternative use, no cost should be reflected for reproducing this surplus capacity. However, where there is an alternative use that is physically possible and financially feasible, we believe that the surplus capacity should be included in the valuation, either using fair value (if determinable) or replacement cost. However, surplus capacity is unlikely to have an alternative use unless it is physically and operationally separable from the required capacity.

For example, in addition to the surplus diameter of the pipes, T's network includes an additional discrete segment of pipes that is surplus to requirements, but which could be closed off and used for other purposes such as a liquid storage facility. While the surplus diameter would be ignored for valuation purposes, in our view, the surplus segment should be included in the valuation.

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Possible impairment

In valuing plant and equipment using a DRC valuation, there is a risk that the value attributed to the asset will exceed its recoverable amount (see 3.9). This is because DRC is based on reproduction cost, whereas impairment losses are measured by reference to future cash flows and selling prices.

IAS 36.9

In our view, a DRC valuation always should be accompanied by a review of the future profitability of the business to which the assets being valued relate. When this review indicates a possible impairment, full impairment testing in accordance with IAS 36 is required (see 3.9).

Income approach#

Forthcoming requirements

IAS 16.33

The revised standard also allows fair value to be estimated using an income approach if there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business.

Apportioning values between land and specialised plant

IAS 16.32

In many cases the valuation of specialised plant and equipment is linked to the valuation of the land on which it is situated. The land should be measured at fair value at the date of the revaluation, but an issue arises as to how the valuation of a site should be allocated between the land itself and the specialised plant and equipment on that land.

For example, entity V runs a brewery that is located in a prime residential location. The fair value of the site as a whole is 400; this represents its value for housing development, which would require demolishing the brewery. The DRC valuation of the brewery is 150. V cannot value the land at 400 and the brewery at 150 because the total of 550 is more than the fair value of the site as a whole. In our view, an entity should make an accounting policy election, which should be applied consistently, to either:

- value the land as the difference between the total site value and the DRC valuation of the related plant – 250 in this example; or
- apportion the value of the site to the land and the related plant proportionate to their fair values – in this example the land would be valued at 291 (400/550 x 400) and the brewery would be valued at 109 (150/550 x 400).

A third alternative, which we do not recommend, would be to attribute the entire value of the site to the land because this is where the value lies. In that case the related plant would be valued at zero.

All assets in a class

IAS 16.31, 36-38

If an asset is revalued then all property, plant and equipment of the same class must be revalued at the same time and these revaluations must be kept up to date. A class of assets is a grouping of items that have a similar nature and use in an entity's operations.

In our view, different geographical locations do not justify concluding that the assets are in different classes. For example, entity T has office buildings in Europe and Asia; the buildings in both regions are used for administrative purposes. We believe that the buildings belong to the same class of property, plant and equipment. Accordingly, the buildings in Europe should not be revalued without the buildings in Asia also being revalued.

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Accumulated depreciation

IAS 16.35 When property, plant and equipment is revalued, an entity should make an accounting policy election, which should be applied consistently to all revaluations, to either:

- restate both the gross carrying amount of the asset and the related accumulated depreciation proportionately; or
- eliminate the accumulated depreciation against the gross carrying amount of the asset.

The following example illustrates both of these methods; in our experience the second method is more common.

Entity V revalues all of its land and buildings at the beginning of 2004. The following information relates to one of the buildings:

Gross carrying amount	200
Accumulated depreciation	(80)
Carrying amount	120
Fair value	150

Restate the gross carrying amount and accumulated depreciation

If both the gross carrying amount and the accumulated depreciation are restated, the revised carrying amount of the building will be:

Gross carrying amount	250	200/120 x 150
Accumulated depreciation	(100)	80/120 x 150
Carrying amount	150	

Eliminate accumulated depreciation

If the balance of accumulated depreciation is eliminated, the revised carrying amount of the building will be:

Gross carrying amount	150
Accumulated depreciation	-
Carrying amount	150

Transferring the revaluation surplus to retained earnings

IAS 16.6, 48 The depreciable amount of a revalued asset is based on its revalued amount and not its cost. As noted above, the depreciation charge for each period is recognised as an expense in the income statement (unless it is included in the carrying amount of another asset).

IAS 16.41 However, the revaluation surplus *may* be transferred directly to retained earnings as the surplus is realised. Realisation of the surplus may occur either by the use (and depreciation) of the asset or its disposal. The wording of the standard is not entirely clear, but in our view, an entity has the following choices:

- do not transfer any part of revaluation reserve to retained earnings;
- transfer all of the revaluation reserve to retained earnings upon ultimate disposal; or
- transfer a relevant portion of the revaluation reserve to retained earnings as the asset is depreciated, with the balance being transferred upon ultimate disposal.

Continuing the above example, at the date of the revaluation the building has a remaining useful life of 15 years and is depreciated on a straight-line basis; the revaluation reserve is 30. Regarding the third option above, each year an amount of two will be transferred from the revaluation reserve to

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retained earnings to match the additional depreciation of two that relates to the revalued portion of the asset (30/15). (This example ignores the impact of deferred tax, which is discussed in 3.12.)

Change in accounting policy

IAS 8.17

If an entity changes its accounting policy from cost to fair value, the effect of the change is recognised as a revaluation (see above); the opening balance of equity is not adjusted and comparatives are not restated (see 2.8).

When an entity changes its accounting policy from fair value to cost, all previous revaluations, including subsequent depreciation charges, should be reversed. In this case the usual procedures for a change in accounting policy apply (i.e., the effect of the change is calculated retrospectively and the adjustment is recognised either by adjusting the opening balance of retained earnings or in the current period – see 2.8).

3.2.7 Compensation received

IAS 16.65, 66

Compensation for the loss or impairment of property, plant and equipment is recognised in the income statement when receipt is virtually certain (see 3.13). The loss or impairment of the property, plant and equipment is recognised in the income statement as an expense when it occurs.

For example, entity W's main operating plant is destroyed in a fire. The carrying amount of the plant was 600. W's insurers pay out an amount of 1,000, which comprises 800 for the rebuilding of the plant and 200 for loss of profits. The actual cost of rebuilding the plant is 900.

The following journal entries will be recorded by W:

	Debit	*Credit*
Income statement (loss)	600	
Property, plant and equipment		600
Entry to record the loss of the plant		
Cash	1,000	
Income statement (income)		1,000
Entry to record the insurance proceeds		
Property, plant and equipment	900	
Cash		900
Entry to record the cost of the new plant		

Recognition of the loss or impairment may occur at a different point (and even in a different period) than the recognition of the compensation.

3.2.8 Retirements and disposals

IAS 16.67, 71

When an item of property, plant and equipment is disposed of or permanently withdrawn from use, a gain or loss is recognised for the difference between any net proceeds received and the carrying amount of the asset#. Any attributable revaluation surplus may be transferred to retained earnings (see 3.2.6), but is not recognised in the income statement.

In determining the "net" proceeds received, generally all directly attributable incremental costs of disposal, such as advertising, legal fees, stamp duty, agency fees and removal costs, are deducted. In our view, it also would be appropriate to deduct any amounts recognised as liabilities under IAS 37 (see 3.11) in relation to the disposal of the asset, such as provisions made for probable claims under warranties in the sales agreement, or for an agreed schedule of repairs to be done at the current owners' expense.

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Forthcoming requirements

IAS 16.68, 69 The revised standard clarifies that the gain or loss on derecognition is included in the income statement (unless the transaction is a sale and leaseback and deferral is required – see 5.1) and is not classified as revenue. The date of disposal of an asset is determined by applying the revenue recognition criteria (see 4.2) unless the disposal is by sale and leaseback in which case IAS 17 applies (see 5.1).

IAS 16.59 (1998) When an item of property, plant and equipment is withdrawn from active use and is held for disposal, depreciation stops and the carrying amount of the asset is frozen (subject to the recognition of any impairment loss – see 3.9)#. In our view, the asset should be removed from property, plant and equipment and placed in a separate category of assets "held for disposal"; the asset would be classified as current or non-current depending on the expected period to disposal (see 3.1).

Forthcoming requirements

IFRS 5.6, 15 When an asset's carrying amount is to be recovered principally through a sale transaction rather than through continuing use, IFRS 5 requires that an entity classifies the asset as a non-current asset (or disposal group) held for sale. Depreciation of that asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) and the date that the asset is derecognised. An entity measures such a non-current asset (or disposal group) at the lower of its carrying amount and fair value less costs to sell (see 5.4A).

IAS 16.59 (1998) When an asset is withdrawn from active use on a temporary basis, depreciation should continue#.

Forthcoming requirements

IAS 16.55 The revised standard clarifies that an entity must continue to recognise depreciation even when an asset is idle and retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Exchanges of non-monetary assets are discussed in 5.7.

3.2.9 Government grants

IAS 20.23-28 The treatment of a government grant that relates to property plant or equipment is discussed in 4.3. A government grant may be related to an item of property plant or equipment whether it is received in cash or when an asset is received by way of a non-monetary grant.

3.2.10 Disclosure

IAS 16.73 The disclosure requirements in IAS 16, examples of which are included in KPMG's *Illustrative financial statements*, include a reconciliation between the carrying amount of property, plant and equipment at the beginning and end of the period. The reconciliation is required for the current period only (i.e., a reconciliation is not required as part of the comparatives)#.

Forthcoming requirements

IAS 16.73 The disclosure requirements of the revised standard require a reconciliation between the carrying amount of property, plant and equipment at the beginning and end of the period for the comparative period as well.

IAS 16.73 The reconciliation includes separate line items for additions and acquisitions through business combinations. Therefore, acquisitions should be split between property, plant and equipment acquired in a business combination and other acquisitions. However, all disposals are presented in a single line item in the reconciliation.

IAS 16.73 The calculation of the net exchange difference in respect of foreign entities, which is part of the reconciliation, is illustrated in 2.7.

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3.2.11 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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3.3 Intangible assets and goodwill

(IFRS 3, IAS 22, IAS 38, SIC–6, SIC–32)

Overview

IFRS 3 *Business Combinations* and IAS 38 *Intangible Assets* introduce significant changes to the accounting discussed below for intangible assets and goodwill.

- **For an item to be recognised as an intangible asset, it must have future economic benefits that it is probable will be realised and its cost must be reliably measurable.**
- **Intangible assets are recognised initially at cost.**
- **The measurement of the cost of an intangible asset depends on whether it has been acquired separately, acquired as part of a business combination or was generated internally.**
- **Goodwill represents future economic benefits that cannot be identified individually and recognised separately and therefore is measured as a residual.**
- **Intangible assets and goodwill are amortised over their useful lives, which generally does not exceed 20 years#.**
- **Subsequent expenditure is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset, and it can be distinguished from developing the business as a whole#.**
- **Intangible assets may be revalued to fair value only if there is an active market.**
- **The following costs cannot be capitalised as intangible assets: internally generated goodwill, research costs, costs to develop customer lists, start-up costs, and expenditure incurred on training, advertising and promotional activities or on relocation or reorganisation.**

Forthcoming requirements

In March 2004, the IASB issued a revised version of IAS 38 *Intangible Assets* and issued IFRS 3 *Business Combinations* to supersede IAS 22 *Business Combinations*. The revised standards apply prospectively for intangible assets acquired in a business combination for which the agreement date is on or after 31 March 2004 and to other intangible assets from the beginning of the first annual period beginning on or after 31 March 2004 with three exemptions (see 3.3.8). Also, an entity can adopt the requirements of IFRS 3 early if it meets certain criteria (see 3.3.8). Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, goodwill and intangible assets with an indefinite useful life are not amortised but are tested for impairment at least annually. Intangible assets with finite useful lives continue to be amortised.

The IASB is considering further significant changes to accounting for business combinations (see 3.3.9).

3.3.1 Definitions

Goodwill

IAS 22.41 (1998)

Goodwill arising in a business combination is the excess of the cost of acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired (see 2.6)#.

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Forthcoming requirements

IFRS 3.51 IFRS 3 expands the existing description of goodwill. It also changes the amount likely to be attributed to goodwill by requiring recognition of acquired contingent liabilities. Goodwill represents future economic benefits arising from assets that are not capable of being identified individually and recognised separately. Goodwill arising in a business combination is measured initially as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquired identifiable assets, liabilities and *contingent* liabilities recognised (see 2.6).

Intangible assets

IAS 38.7 (1998) An intangible asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others or for administrative purposes#.

Forthcoming requirements

IAS 38.8 IFRS 3 modifies the definition of an intangible asset. Under IFRS 3 an intangible asset is an identifiable non-monetary asset without physical substance. There is no requirement that the asset is held for a particular purpose (i.e., the asset need not be held for use in the production or supply of goods or services, for rental to others, or for administrative purposes).

IAS 38.8-17 To meet the definition of an intangible asset, an item must lack physical substance and must be:

- *"identifiable"*;
- *non-monetary*; and
- controlled by the entity and expected to provide future economic benefits to the entity (i.e., it must meet the definition of an asset).

These criteria are explained below and apply to all intangible assets, whether acquired separately, acquired in a business combination or internally generated.

Identifiability

IAS 38.10-12 (1998) In order for an intangible asset to be recognised it must be *identifiable* so that it clearly can be distinguished from goodwill#. An item is identifiable (i.e., clearly distinguishable from goodwill) if:

- it is separable (i.e., it could be rented, sold, exchanged or distributed without also disposing of the future economic benefits that flow from other assets used in the same revenue generating activity);
- it is protected by legal rights; or
- the entity can identify the future economic benefits that will flow from the item, even if those benefits are derived only in combination with other assets#.

Forthcoming requirements

IAS 38.12 The revised standard states that the identifiability criterion is met when the item:

- is separable (i.e., is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or liability); or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Either of the above conditions is sufficient for an intangible item to be identifiable.

IAS 38.12 Therefore, separability is not a necessary condition for an item to be identifiable. For example, a business licence of a radio station that the station needs to operate is identifiable because of the legal rights attached to it, even though the license usually is not separable from the station operator.

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In our experience, the decision of whether the identifiability criterion is met often is the critical factor in determining whether the definition of an intangible asset is met and whether an intangible asset can be recognised on the balance sheet.

Forthcoming requirements

IFRS 3.1E The illustrative examples in IFRS 3 include examples of items that generally meet the definition of an intangible asset (provided they meet the identifiability criterion which generally is assumed for items listed).

For example, entity A is a successful engineering business. In 2003 A decides to apply for ISO accreditation, which requires A to document and formalise all of its procedures. In our view, ISO accreditation generally will not meet the definition of an intangible asset because, in most cases, it is not separable and it does not have any legal rights attached to it.

Non-monetary

Intangible assets are required to be non-monetary since a monetary intangible would be a financial asset within the scope of IAS 39 (see 3.6).

Control

IAS 38.13-16 In order to demonstrate control an entity must have the power to obtain the future economic benefits arising from the item *and* be able to restrict the access of others to those benefits.

IAS 38.15 For example, entity C has two key resources: customised software that it developed in-house and for which a patent is registered; and the "know-how" of the staff that operate the software. Staff are required to give one month's notice of their resignation. It is clear that C controls the software. However, although it obtains economic benefits from the work performed by the staff, C does not have control over their know-how because staff could choose to resign at any time. Therefore, the know-how does not meet the definition of an intangible asset.

IAS 38.15 In another example, entity D is a football club. D has contracts with individual players that entitle it to receive that player's services and prevent that player from leaving the club or providing services to another club. These contracts meet the definition of an intangible asset because they give D control over future economic benefits through its contractual rights.

IAS 38.16 One difficult area is customer-related intangible assets; examples include customer relationships, customer lists and market share. For example, entity E provides an excellent relocation service and over the years has become the favoured supplier for a number of customers. However, although these customers generally refer all of their relocations to E, they are not obliged to do so and at any time they could change suppliers. Therefore, E does not have control over these relationships and accordingly the definition of an intangible asset is not met#.

In another example, entity F installs residential security systems and provides a 24-hour security service. Customers are required to sign an initial contract for 12 months; if they cancel at any time within the initial period, F is entitled to impose a penalty. In this case the customer relationship meets the definition of an intangible asset because F has control of the future economic benefits that arise during the initial contract period.

In accordance with IAS 39 a low-interest loan is recognised initially at fair value and this gives rise to a difference that may be capitalised if it meets the definition of an asset (see 3.6). For example, entity G manufactures and distributes a sparkling drink that is very popular among teenagers. G extends low-interest loans to a number of small retailers that agree to stock only G's brand of sparkling drink. A retailer repays the loan by paying an above-market price for the drinks that it buys from G. If the retailer decides to stop selling the drinks, the outstanding amount of the loan becomes repayable immediately. In our view, the difference arising on the initial recognition of the

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low-interest loan meets the definition of an intangible asset because G has control over the relationship with the retailer.

IAS 38.63 A customer list is another example of a customer-related intangible. In our view, an acquired customer list might meet the definition of an intangible asset even if the entity does not control the customer relationship; this is because the entity does control the list of names#. However, before reaching a final conclusion it would be necessary to consider also whether the customer list is identifiable (see above) and whether future economic benefits arising from the list itself are expected to flow to the entity. In some countries regulations exist that prevents an entity from selling, leasing or exchanging information contained in such a list. The existence of such regulation or similar agreements may affect the benefits expected to arise from the list. As noted above, an internally generated customer list cannot be capitalised.

Forthcoming requirements

IAS 38.13, 16 The revisions to IAS 38 relating to IFRS 3 broadened the circumstance in which intangible assets are recognised. Control normally stems from legal rights that are enforceable in a court of law (which is equivalent to the 'contractual or other legal rights' – a criterion for identifiability). The standard clarifies that control may be demonstrated by other means than legally enforceable rights and therefore legal enforceability is not a necessary condition for control.

For example, in the absence of legal rights to protect customer relationships, control of customer relationships may be evidenced by exchange transactions for the same or similar non-contractual customer relationships (which is equivalent to 'separability' – a criterion for identifiability). Therefore, non-contractual customer relationships meet the definition of an intangible asset if there are exchange transactions of similar assets, because such exchange transactions provide evidence that the customer relationships are separable as the entity is able to control the expected future economic benefits flowing from the customer relationship.

In our view, demonstration of separability through exchange transactions for the same or similar intangible assets generally provides evidence of control; the use of exchange transactions to demonstrate identifiability is not limited to non-contractual customer relationships.

In our view, the control criterion in the definition of an intangible asset is met when the identifiability criterion is met.

IFRS 3.16, IE The illustrative examples in IFRSs include contract-based customer relationships acquired in a business combination. These examples illustrate that, in a business combination, the identifiability criterion can be satisfied even if a contract does not exist at the date of the business combination, if there is a practice of establishing such contracts. It also is not necessary that the contracts be non-cancellable.

3.3.2 Initial recognition

General requirements

IAS 38.21 An intangible asset that meets the following criteria is recognised initially at cost:

- it is probable that future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

IAS 38.25 The 'probability' recognition criterion always is considered to be satisfied for intangible assets acquired separately.

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IAS 38.8, 26 The cost of an intangible asset acquired in a separate transaction is the cash paid or the fair value of any other consideration given. In practice the cost can be difficult to establish if no cash is involved in the transaction, and care should be taken to ensure that there is a reasonable basis for the amount attributed to the intangible asset. Non-monetary transactions are considered further in 5.7.

IAS 38.27, 28, 65, 69 The cost of an intangible asset includes directly attributable expenditure of preparing the asset for its intended use, and the principles discussed in respect of property, plant and equipment (see 3.2) apply equally to the recognition of intangible assets. IAS 38 is specific that expenditure on training activities is expensed as incurred. In addition, clearly identified inefficiencies and initial operating losses should be expensed as incurred.

IAS 38.32 When payment is deferred, the cost of the asset is the cash price equivalent. The issues that arise in accounting for deferred payment are similar to those in respect of property, plant and equipment (see 3.2).

IAS 38.33-41 The cost of an intangible asset acquired in a business combination is its fair value. Fair value reflects the market's view about the probability of future economic benefits. Therefore, the probability criterion always is satisfied. Fair value may be established using valuation techniques if there is no active market for the acquired intangible. However, if the intangible asset is not valued by reference to an active market, the value placed on the asset is limited to an amount that does not create or increase negative goodwill#. Fair value of assets acquired in a business combination normally can be measured with sufficient reliability to be recognised separately from goodwill.

Care should be taken in valuing an intangible asset to ensure that the valuation does not include any value attributable to other assets. For example, the fair value of a customer list is the value of the list of names; the value should not include any amount attributable to the customer relationships#.

Forthcoming requirements

IFRS 3.IE, B Under IFRS 3, acquired customer relationships are intangible assets that should be recognised separately from goodwill.

Specific application

Research and development

IAS 38.8, 54 Research is original and planned investigation undertaken with the prospect of gaining new knowledge and understanding. Research costs are expensed as incurred.

IAS 38.8 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, products, processes etc.; it does not include the maintenance or enhancement of ongoing operations.

Development does not need to be on entirely new innovation; rather, it needs simply to be new to the specific entity. For example, entity K is developing a new IT system for processing its customer orders. The project meets the definition of development notwithstanding the fact that most of K's competitors use similar systems already.

IAS 38.57 If an internally generated intangible asset arises from the development phase of a project, directly attributable expenditure *must* be capitalised from the date that the entity is able to demonstrate:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

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- its ability to measure reliably the expenditure attributable to the intangible asset during its development.

IAS 38.57, 60

In assessing how the intangible asset will generate probable future economic benefits, the entity must demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself; or, if it is to be used internally, the usefulness of the intangible asset. In carrying out this assessment an entity uses the principles of the standard on impairment. If the asset will generate economic benefits only in combination with other assets, the entity should apply the concept of cash-generating units (see 3.9).

Although "probable" is not defined in IAS 38, it does not mean that a project must be certain to succeed prior to capitalising any development costs. For example, in our view, a pharmaceutical entity should not expense all development costs as incurred simply because there is a *possibility* that new medicines will not be approved for sale by the relevant authorities. Rather, an assessment should be made of the likelihood of success in each individual case. If a positive outcome is determined to be probable, then the entity should capitalise the related development costs incurred after success is determined to be probable.

IAS 38.61

Financial and other resources needed to complete the development are not required to be secured at the onset of the project. Often entities can demonstrate their ability to secure these resources through business plans and external financing plans in which potential customers, investors or lenders have expressed interest.

IAS 38.63, 64

IAS 38 specifically prohibits capitalisation of expenditure on internally generated intangible assets such as brands, mastheads, publishing titles, customer lists and similar items. This is because expenditures cannot be distinguished from developing the business as a whole. As a result, the expenditures on any intangible that may be created are viewed as not reliably measurable.

For example, entity B has developed a successful business based on products that have a distinct house style and design signature. B uses its unique house style to develop a standard format for product development. In our view, the standard format does not meet the definition of an intangible asset because the asset is an integral part of the goodwill of the business and cannot be identified separately.

IAS 38.56(b) (1998)

If an acquired entity has 'in-process research and development' an acquirer must consider if there are any identifiable intangibles that satisfying the recognition criteria relating to that in-process research and development. If not, the related cost of the acquisition is recognised as part of the residual (i.e., goodwill) and not as an expense as part of, or immediately after, the acquisition#.

Forthcoming requirements

IAS 38.34

Under the revised standard, in-process research and development is recognised when acquired in a business combination if it meets the definition of an intangible asset and is identifiable.

Web site development costs

SIC 32.14

Costs associated with Web sites developed for advertising or promotional purposes are expensed as incurred.

SIC 32.9, 16

In respect of other Web sites, expenditures incurred during the application and infrastructure development stage, the graphical design stage and the content development stage are capitalised if the criteria for capitalising development costs (see above) are met. The costs of developing content for advertising or promotional purposes are expensed as incurred.

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Goodwill

IFRS 3.51 Goodwill arising in a business combination must be capitalised (see 2.6).

IAS 38.48 Internally generated goodwill is never recognised.

Items that must be expensed as incurred

IAS 38.48, 69 Expenditure associated with the following costs must be expensed as incurred regardless of whether the general criteria for recognition appear to be met:

- internally generated goodwill;
- start-up costs unless they qualify for recognition as part of the cost of property, plant and equipment (see 3.2);
- training activities;
- advertising and promotional activities (see above); and
- expenditure on relocating or reorganising part, or all, of an entity.

Except as noted above in relation to start-up costs, these costs cannot be capitalised either as stand-alone intangible assets or as a part of the cost of another intangible asset; there are no industry or other exceptions.

IAS 38.70 However, this requirement does not prevent the recognition of an asset for prepaid expenses following the principles of accrual accounting. For example, entity L produces a catalogue every year for its new range of products. In our view, the costs of preparing and producing the catalogue should be recognised as prepaid expenses, and then written off as the catalogues are distributed to customers.

3.3.3 Amortisation

IAS 22.44, 54 (1998), 38.79, 94 (1998) Subsequent to initial recognition intangible assets, including goodwill, are amortised over their useful life, which should be reviewed at each balance sheet date#.

Forthcoming requirements

IFRS 3.54, 55, IAS 38.88, 107 After initial recognition, the new standard requires goodwill to be measured at cost less accumulated impairment charges. Goodwill is not amortised, as previously required under IAS 22, but instead is subject to impairment testing at least annually. Under the revised IAS 38 the useful life of an intangible is either finite or indefinite. Intangibles with *indefinite* useful lives must be tested for impairment at least annually, but they are not amortised. Intangibles with *finite* useful lives are amortised and must be tested for impairment under the general requirements of IAS 36 *Impairment of Assets*.

A change in the useful life is accounted for prospectively as a change in accounting estimate (see 2.8).

For example, entity M acquired software at the beginning of 1997 and its useful life was estimated to be 10 years. At the end of 2003 the carrying amount of the software is 240. At the beginning of 2004 M revises the estimated useful life downwards to a further two years from that date. Therefore, the carrying amount of 240 should be amortised over the next two years. In addition, the decrease in useful life may indicate that the carrying amount of the software is impaired (see 3.9).

Residual value

IAS 22.44 (1998) The full carrying amount of goodwill is amortised (i.e., the residual value is zero in all cases)#.

Forthcoming requirements

IFRS 3.54 Under the new standard, goodwill acquired in a business combination is not amortised and therefore no assessment of residual value is required for the purpose of amortisation.

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IAS 38.7, 91, 92 (1998) An intangible asset's depreciable amount is its cost less its residual value; an intangible asset's residual value is based on similar intangible assets that have reached the end of their useful lives at the date that the estimate is made#.

Forthcoming requirements

IAS 38.100, 107 The revised standard distinguishes between intangible assets with finite and indefinite useful lives. Intangible assets with an indefinite useful life are not amortised and no assessment of residual value is required for the purpose of amortisation.

IAS 38.8, 100 Revised IAS 38 modifies the definition of residual value to deduct disposal costs. Under revised IAS 38 the depreciable amount of an intangible asset with a finite useful life is determined after deducting its residual value. The residual value of an intangible asset is the estimated amount that an entity would obtain currently from disposal of the asset, after deducting the estimated costs of disposal, if the asset were in the condition expected at the end of its useful life.

However, unlike property, plant and equipment, the residual value is assumed to be zero unless:

- a third party has committed to buy the asset at the end of its useful life; or
- there is an active market (see 3.3.5 *Revaluations* below) from which a residual value can be obtained, and it is probable that such a market will exist at the end of the asset's useful life.

IAS 38.101 The effect of these criteria is that generally in practice the residual value of an intangible asset is assumed to be zero. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.

IAS 38.63 (1998) Subsequent to initial recognition residual values are not changed for increases in prices unless the asset is revalued, in which case a new estimate of the residual value is made#. This is consistent with the estimation of residual values for property, plant and equipment (see 3.2).

Forthcoming requirements

IAS 38.102, 103 Under the revised standard the residual value of an intangible asset is reviewed at least at each financial year-end. A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with IAS 8 (see 2.8). If the residual value of an intangible asset increases to an amount equal to or greater than the asset's carrying amount, then amortisation stops until its residual value subsequently decreases to an amount below the asset's carrying amount.

Useful life

IAS 22.44, 88 (1998), 38.79, 111 (1998) There is a rebuttable presumption that the useful life of intangible assets, including goodwill, will not exceed 20 years. When a longer useful life is used, an entity must disclose the reasons why the presumption was rebutted and the factors that played a significant role in determining the asset's useful life#.

Forthcoming requirements

IFRS 3.55, IAS 38.88 The revised standard no longer has a rebuttable presumption that the useful life of intangible assets, including goodwill, will not exceed 20 years. Instead, goodwill acquired in a business combination is presumed to have an indefinite life and therefore goodwill is not amortised. An entity determines whether the useful life of other intangibles is finite or indefinite. An intangible asset has an indefinite useful life when, based on an analysis of all of the relevant factors (e.g., legal, regulatory, contractual), there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

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IAS 38.85 (1998)

When control of an intangible asset is based on legal rights that have been granted for a finite period, the useful life cannot exceed that period unless:

- the legal rights are renewable; and
- renewal is virtually certain#.

Forthcoming requirements

IAS 38.94-96

Revised IAS 38 expands the requirements for overriding the contract period. The revised standard requires that when the useful life of the intangible asset is based on legal rights that have been granted for a finite period, the useful life cannot exceed that period unless:

- the legal rights are renewable; and
- there is evidence to support that they will be renewed.

In addition, the cost of renewal of such rights should not be significant. If the cost of renewal of such rights is significant when compared with the future economic benefits expected to flow to the entity from renewal, the renewal costs represent the cost to acquire a new intangible asset at the renewal date.

It is not possible to select an infinite useful life and thereby avoid an amortisation charge#.

Forthcoming requirements

IAS 38.88, 91, 107-109

Under the revised standard, an intangible asset may have an indefinite useful life when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. Intangibles with *indefinite* useful lives must be tested for impairment at least annually, but these intangibles are not amortised. The useful life of an intangible asset that is not being amortised must be reviewed at least annually to determine whether events and circumstances continue to support an indefinite useful life for that asset.

If there is a change in the assessment from indefinite to finite due to change in the events and circumstances, then such a change is accounted for as a change in estimate in accordance with IAS 8 (see 2.8).

Similarly, the requirement to assess the useful life of an intangible asset means that it is not possible to amortise an intangible asset over an unrealistically short period in order to avoid ongoing amortisation charges.

For example, entity N capitalises an intangible asset. N assesses the useful life of the intangible as five years but wishes to write it off in the year of purchase in order to avoid ongoing amortisation charges. Assuming that the intangible is not impaired (see 3.9), it should be amortised over its useful life.

Methods of amortisation

Goodwill

IAS 22.45 (1998)

Goodwill is amortised on a straight-line basis unless there is persuasive evidence that another method is more appropriate#.

Forthcoming requirements

IFRS 3.54, 55

Under the revised standard, goodwill acquired in a business combination is not amortised. Instead, it is tested for impairment at least annually.

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Other intangible assets

IAS 38.97, 104

The method of amortisation, which should be reviewed at each balance sheet date, should reflect the pattern of consumption of the economic benefits. A change in the method of amortisation is accounted for prospectively as a change in accounting estimate (see 2.8).

IAS 38.97, 98

IAS 38 does not require a specific method of amortisation to be used, and mentions the straight-line method, the diminishing (or reducing balance) method and the units of production method; these methods are illustrated in 3.2. However, the standard indicates that there rarely will be persuasive evidence to support an amortisation method that results in a lower amount of accumulated amortisation than what would be recognised had the straight-line method been used. If the pattern in which the asset's economic benefits are consumed cannot be determined, the straight-line method is used.

Commencement and cessation of amortisation

IAS 38.79 (1998)

Goodwill is amortised from the date of acquisition (see 2.6)#.

Forthcoming requirements

IFRS 3.54, 55

Goodwill is not amortised but is tested for impairment at least annually.

The amortisation of other intangible assets begins when the intangible asset is available for use, which may be prior to the asset being brought into use#.

For example, entity P develops new software for its human resources department. The software is completed in October 2003 and could be implemented at that date. However, management decides not to implement the software until early in 2004. In our view, the software should be amortised from October 2003.

Forthcoming requirements

IAS 38.97

The revised standard clarifies that the amortisation must begin when the asset is available for use (i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management).

IAS 38.97

Amortisation ceases at the earlier of the date that the asset is:

- classified as held for sale in accordance with IFRS 5; or
- derecognised.

Classification of amortisation expense

IAS 38.99

When an intangible asset is used in the production of another asset (e.g., inventory) the amortisation charge is included in the cost of that asset. In other cases amortisation is recognised as an expense in the income statement. When an entity classifies its expenses by function (see 4.1), care should be taken in allocating the amortisation of intangible assets.

For example, entity P's human resources department is part of the administrative function of the business. Therefore, amortisation of the department's software should be included with administrative expenses.

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3.3.4 Subsequent expenditure#

IAS 38.60 (1998) Expenditure incurred subsequent to the completion or acquisition of an intangible asset is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset and it can be measured and attributed to the asset reliably. Expenditure incurred simply to restore or maintain the level of future economic benefits is expensed as incurred.

For example, entity Q acquired entity R in a business combination. After the acquisition Q carries out a project to migrate the data from R's IT system to its own system so that the group has a single system; no new functionality is added to Q's IT system as part of the project. In our view, the costs incurred to migrate R's data should not be capitalised because the migration does not increase the future economic benefits attributable to the IT system. In addition, a migration is similar to a relocation, the costs of which cannot be capitalised (see 3.3.2).

IAS 38.20 In addition, expenditure may be capitalised only when it can be attributed reliably to the specific intangible asset (i.e., the expenditure must be distinguishable from costs incurred on the business as a whole). The standard concludes that subsequent expenditure will be capitalised only in rare cases.

IAS 38.20 Consistent with the requirements in respect of initial recognition (see 3.3.2), subsequent expenditure on items such as brands, mastheads, publishing titles and customer lists should not be capitalised. This is on the basis that the expenditure cannot be distinguished from developing the business as a whole and therefore it cannot be identified separately from goodwill.

Forthcoming requirements

IAS 38.20 Revised IAS 38 clarifies that it will be rare for subsequent expenditure to be recognised in the carrying amount of an intangible asset (see also 3.3.7). It often is difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. In addition, most subsequent expenditure is likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria of the revised IAS 38.

IAS 38.42, 54-62 The general recognition criteria for internally generated intangible assets are applied to subsequent expenditure on in-process research and development projects acquired separately or in a business combination (i.e., capitalisation after initial recognition is limited to development costs that meet the recognition criteria).

3.3.5 Revaluations

IAS 38.8, 75 Intangible assets for which there is an active market may be revalued to fair value. An active market exists when:

- the items traded are homogenous;
- willing buyers and sellers normally can be found at any time; and
- prices are available to the public.

IAS 38.78 Many intangible assets may not be revalued as they are considered unique and therefore there is no active market for them; examples include customised software, brands, mastheads, publishing rights, patents and trademarks.

IAS 38.72, 85, 86 If an intangible is revalued then all intangibles in that class must be revalued (to the extent that there is an active market for these intangibles) and the revaluations must be kept up to date. Any surplus arising on the revaluation is taken directly to a revaluation reserve within equity except to the extent that the surplus reverses a previous revaluation deficit on the same asset charged in the income statement, in which case a credit up to the amount of the deficit previously charged to income is recognised in the income statement. Any deficit on revaluation is charged in the income statement

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except to the extent that it reverses a previous revaluation surplus on the same asset, in which case it is taken directly to the revaluation reserve. Therefore, under IFRSs revaluation increases and decreases within a class of assets cannot be offset.

IAS 8.16, 17, 38.80, 87 Certain other issues relating to the revaluation of intangible assets are similar to those that arise in respect of property, plant and equipment (see 3.2).

3.3.6 Impairment

IAS 38.99, 106 (1998) Impairment testing of intangible follows the general impairment requirements (see 3.9) except that the following must be tested for impairment annually:

- intangible assets, including goodwill, with a useful life greater than 20 years;
- capitalised intangible assets prior to being available for use; and
- intangible assets that have been retired from active use and held for disposal (see 3.3.7).

Forthcoming requirements

IAS 36.10, 96 Under the revised IAS 36 an annual impairment test is required for the following assets:

- goodwill acquired in a business combination, which must be tested for impairment annually and at any point during the year when an indicator of impairment exists; and
- intangible assets with an indefinite useful life and intangible assets not yet available for use for which the recoverable amount must be measured annually, irrespective of whether there is an indication that the related assets may be impaired, as well as whenever there is any indication that they may be impaired.

3.3.7 Retirements and disposals

Goodwill

IAS 36.86 When the underlying investment to which goodwill relates is disposed of, the carrying amount of the goodwill is included in calculating the gain or loss on disposal (see 2.5).

However, when the goodwill arose prior to 1995 and was recognised directly in equity, it is our view that an entity may not transfer the attributable goodwill to the income statement as part of the calculation of the gain or loss on disposal#.

Forthcoming requirements

IFRS 3.80 Under the new standard, goodwill recognised previously as a deduction from equity should not be recognised in the income statement when the entity disposes of all or part of the business to which that goodwill relates.

Intangible assets

IAS 38.87, 112, 113 When an intangible asset is disposed of or when no further economic benefits are expected from its use, the gain or loss is the difference between any proceeds received and the carrying amount of the asset. Any attributable revaluation surplus may be transferred to retained earnings (see 3.3.5), but is not recognised in the income statement.

Forthcoming requirements

IAS 38.115 Revised IAS 38 clarifies that if an entity recognises the cost of a replacement for a part of an intangible asset in the carrying amount of an intangible asset, then it must derecognise the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

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IAS 38.116 The revised standard clarifies that the consideration receivable on disposal of an intangible asset is recognised initially at its fair value. If payment for the intangible asset is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with IAS 18 (see 4.2) reflecting the effective yield on the receivable.

IAS 38.106 (1998) When an intangible asset is withdrawn from active use and is held for disposal, amortisation stops and the carrying amount of the asset is frozen subject to the recognition of any impairment loss – (see 3.9). In our view, the asset should be removed from intangible assets and placed in a separate category of assets "held for disposal"; the asset would be classified as current or non-current depending on the expected period to disposal (see 3.1)#.

Forthcoming requirements

IAS 38.117 Under the revised standard amortisation of an intangible asset with finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale in accordance with IFRS 5. Under IFRS 5 non-current assets held for sale are presented separately from other assets in the balance sheet (see 5.4A).

Exchanges of non-monetary assets are discussed in 5.7.

Disclosure

IAS 38.118 The disclosure requirements of IAS 38, which are illustrated in KPMG's *Illustrative financial statements* series, include a reconciliation between the carrying amount of intangible assets at the beginning and end of the period. The reconciliation is required for the current period only (i.e., a reconciliation is not required as part of the comparatives)#.

Forthcoming requirements

IAS 38.118 Revised IAS 38 requires comparative amounts to be presented for this reconciliation.

IAS 38.118 The reconciliation for intangible assets other than goodwill includes separate line items for additions and acquisitions through business combinations. Therefore, acquisitions should be split between intangible assets acquired in a business combination and other acquisitions. However, all disposals are presented in a single line item in the reconciliation.

IAS 38.118 The calculation of the net exchange difference in respect of foreign entities, which is part of the reconciliation, is illustrated in 2.7.

3.3.8 Limited exemptions from effective date

IFRS 3.78-82 IFRS 3 and the revisions to IAS 36 and IAS 38 are applied prospectively from **31 March 2004** with three exemptions:

- existing goodwill – amortisation of existing goodwill will continue until the beginning of the first annual reporting period beginning on or after 31 March 2004. At that date, the carrying value of the goodwill will be frozen and tested for impairment under IAS 36 (see 3.9).
- existing intangible assets – existing intangibles that do not meet the recognition criteria should be reclassified to goodwill from the beginning of the first annual reporting period beginning on or after 31 March 2004. Any changes to recognised amounts should be accounted for according to IAS 8 (see 2.8). However, intangible assets included in previously recognised goodwill that would meet the revised criteria for separate recognition are not reclassified; and
- negative goodwill – any negative goodwill existing at the adoption date is transferred to the opening balance of retained earnings at the beginning of the first annual reporting period beginning on or after 31 March 2004.

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IFRS 3.85 An entity is permitted to apply IFRS 3 from any date before 31 March 2004 if:

- the valuations necessary to comply with the standard were obtained at the time of the initial accounting; and
- the revised IAS 36 and IAS 38 also are applied from the same date.

3.3.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The IASB's second phase business combinations project will have an impact on the requirements discussed in this section.

An exposure draft is expected in late 2004. The IASB is expected to propose requiring recognition of the full amount of goodwill. Therefore, goodwill would not be measured by reference to the acquirer's share of the fair value of identifiable assets and liabilities acquired (see 2.6).

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3.4 Investment property

(IAS 40)

Overview

- **Investment property is property held to earn rentals or for capital appreciation or both.**
- **Investment property accounting is required for all investment property.**
- **A portion of a dual-use property is classified as investment property only if the portion could be sold or leased out under a finance lease. Otherwise the entire property is classified as property, plant and equipment, unless the portion of the property used for own-use is insignificant.**
- **When ancillary services are provided, a property is classified as investment property if such services are a relatively insignificant component of the arrangement as a whole.**
- **When a property is managed by a third party, criteria should be developed in order to classify such property as either investment property or property, plant and equipment on a consistent basis.**
- **Investment property is recognised initially at cost.**
- **Subsequent to initial recognition, all investment property should be measured either by using the fair value model (subject to limited exceptions) or by using a cost model. Disclosure of the fair value of all investment properties is required, regardless of the measurement model used.**
- **Subsequent expenditure is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset#.**
- **Transfers to or from investment property can only be made when there has been a change in the use of the property.**
- **The gain or loss on disposal is the difference between the net disposal proceeds and the carrying amount of the property.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 40 *Investment Property* and IAS 17 *Leases*. The revised standards are effective for accounting periods beginning on or after 1 January 2005. Early adoption is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standards permit property held by a lessee under an operating lease to be classified as investment property if the rest of the definition of investment property is met and the lessee measures the property at fair value.

3.4.1 Definition

IAS 40 is not a specialised industry standard. Therefore, determining whether a property is investment property depends upon the use of the property rather than the type of entity that holds the property.

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IAS 40.5 Investment property is property held to earn rental income or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

For example, a retail site owned by entity A, but leased out to third parties in return for rental income, is an investment property; however, a factory owned and used by entity B is not an investment property because it is used in the production of goods.

IAS 40.14 Although the above definition appears relatively straightforward, determining what is or is not an investment property raises some difficult practical issues. Some of these problem areas are discussed below.

Buildings

IAS 40.5 An investment property may comprise:

- land;
- a building or part of a building; or
- both.

Buildings are not defined in IAS 40 and an issue arises as to whether structures, such as oil storage tanks, dry docks and aircraft hangars, are buildings for the purpose of determining whether the definition of investment property is met. In our view, a building is a permanent structure, built for occupation. Therefore, we would not consider oil storage tanks or dry docks as buildings because they are not built for occupation.

For example, entity C owns a dry dock that is hired out to various third parties; it is not used by C itself. In our view, the dry dock is not a building; therefore, we would account for it as property, plant and equipment in accordance with IAS 16 (see 3.2); the operating lease rentals would be accounted for in accordance with IAS 17 (see 5.1).

IAS 40.4 Even though a structure might not be a building in its own right, it may be regarded as an integral part of the related land in some cases, and therefore, still might meet the definition of investment property; examples include golf courses and car parks. IAS 40 provides specifically that the following are outside the scope of the standard:

- biological assets on land relating to agricultural activities; and
- mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

Equipment and furnishings

IAS 40.50 Equipment and furnishings physically attached to a building are considered to be part of the investment property. So, for example, lifts, escalators, air conditioning units, decorations and installed furniture such as built-in cabinetry would be included as part of the cost and fair value of the investment property and would not be classified separately, as property, plant and equipment.

IAS 40.50 When investment property is leased on a furnished basis, generally its fair value also includes the value of the related movable furniture. In such cases the furniture would not be accounted for as a separate asset if the investment property is accounted for at fair value (see 3.4.4). If the investment property is accounted for using the cost model (see 3.4.4), the related movable furniture should be accounted for as separate assets following the components approach required by IAS 16 (see 3.2). However, in our view, care should be taken to ensure that the disclosure of fair value of the investment property is not misleading.

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Leased property

IAS 40.2 (2000)

IAS 17 (lease accounting), rather than IAS 40, applies to:

- property held under an operating lease in a lessee's financial statements#; and
- property leased out under a finance lease in a lessor's financial statements.

In some countries (e.g., Hong Kong) the outright legal ownership of property is rare. Instead, entities buy and sell rights under long-term leases in the same way that entities buy and sell ownership rights in other countries. In such cases the lease of land is an operating lease because legal ownership does not transfer. However, in the case of the building, it may be that the building is owned outright by the lessee of the land. This might be the case if, for example, during the lease term the lessee is entitled to build or remove any structures on the leased land and if the lease were to terminate, the lessee would have both the right to remove the building and the obligation to do so if the lessor required. Alternatively, it may be that the building is included under the lease of the land, in which case it will be classified as an operating or finance lease after analysing the substance of the lease and the indicators set out in IAS 17#. Section 5.1 discusses the accounting for leases in more detail, including the classification of leases that cover both land and buildings.

Forthcoming requirements

IAS 17.14

Revised IAS 17 clarifies that a lease of land and buildings should be treated as separate leases of the land and of the building. As a result the leases may be classified differently (e.g., the land as an operating lease and the building as a finance lease).

For example, entity D pays 500 to acquire a 200 year leasehold interest in a piece of empty land; legal ownership will not pass at the end of the lease. D constructs and owns a retail building on the land; the building has an estimated useful life of 30 years. The retail premises, which are leased out to third parties in return for rental income, are investment property.

Forthcoming requirements

IAS 40.6

The revised standard permits property held by a lessee under an operating lease to be classified as investment property if the rest of the definition of investment property is met and the lessee measures the property at fair value. In such cases the leasehold interest would be accounted for as if it were a finance lease. The use of the fair value model for property held by a lessee under an operating lease (by classifying the property interest as an investment property) can be elected on an asset-by-asset basis. However, if the fair value model is used for one such asset, all owned investment properties also must be measured using the fair value model.

Inventory versus investment property

IAS 40.9

Property that is held for sale in the ordinary course of business, or which is in the process of construction or development for such sale, is classified as inventory (see 3.7) rather than as investment property.

IAS 40.8, 9

In some cases it may be difficult to distinguish between property held for sale in the ordinary course of business (inventory) and property held for capital appreciation (investment property). The standard gives examples of land held for *long-term* capital appreciation (investment property), land held for *short-term* sale (inventory), and property acquired exclusively with a view to subsequent disposal in the *near future* (inventory). "Short-term", "long-term" and "near future" are not defined in IFRSs and various interpretations are possible.

In practice, "near future" and "short-term" often are interpreted to mean that the disposal will take place within 12 months of the date of acquisition or completion of construction or redevelopment.

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IAS 40.8, 9, 58 In practice the entity's intentions often are critical in determining the classification of a property. For example, entity F acquires bare land with the intention of building residential homes that will be sold upon completion. In our view, on the basis of F's intentions, the land and subsequent construction costs should be classified as inventory. Similarly, if an entity decides to redevelop an existing investment property with the intention of selling the property upon completion, the investment property is transferred to inventories at the date that the redevelopment of the site commences (see 3.4.6). However, a decision to dispose of an investment property without redevelopment does not result in a reclassification to inventory. In this case, the property should continue to be classified as investment property until the time of disposal.

IAS 40.3, 8 Land held for an undetermined future use is classified as investment property. For example, entity E pays 400 to acquire a 100 year leasehold interest in a piece of empty land. E has not yet decided what it will do with the land, but it acquired the interest because it considered the asking price to be a bargain. In accordance with IAS 40 land held for an undetermined future use is classified as investment property.

Property as collateral#

Often financial institutions take possession of property that was originally pledged as security for loans. Such property should be classified as either investment property or property, plant and equipment in the normal way (see 3.2).

IAS 40.8 When a financial institution is uncertain of its intentions with respect to land and buildings that it has repossessed, in our view, they should be classified as investment property. This is consistent with the treatment of land held for an undetermined future use.

Forthcoming requirements

IFRS 5.IG example 3 In March 2004, the IASB issued IFRS 5, which provides guidance on accounting for assets held for sale. Under this new standard, it may be appropriate to classify the property as 'held for sale' (see 5.4A).

Consolidated versus entity financial statements

IAS 27.4, 40.15 In determining the classification of a property in consolidated financial statements, the definition is assessed from the point of view of the group as a single entity. While this is consistent with the requirement for the consolidated financial statements to be presented as those of a single entity (see 2.5), it means that a property might be classified differently in separate entity and consolidated financial statements.

For example, entity G leases an office block to its subsidiary H, which uses the offices as its administrative head office. In G's separate (unconsolidated) financial statements the property is classified as investment property (assuming that the lease is an operating lease). However, in the consolidated financial statements the property is classified as property, plant and equipment because the property is owner-occupied (see 3.2).

IAS 27.4 In our view, the above principles do not apply to property leased to an associate or a joint venture because they are not part of the group. Changing the above example, if G leased the office block to associate J, the property would be classified as investment property in both G's separate (unconsolidated) financial statements as well as in the consolidated financial statements.

IAS 40.15 When assessing the classification of a property leased to, or occupied by, another group entity in the entity's own financial statements, an issue arises as to whether transactions that are not conducted on an arm's length basis should impact the classification. For example, a subsidiary may be instructed to sell a property to another group entity at a price other than fair value, or to transact on other non-commercial terms (e.g., in setting rentals).

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In our view, property leased to related parties, other than own employees, should be regarded as investment properties, provided the asset meets the definition of an investment property. This is irrespective of whether the rents charged are on an arm's length basis or not. The existence of related party relationships and the disclosure of transactions with related parties also would have to be addressed (see 5.5).

Dual-use property

IAS 40.10 Property often has dual purposes whereby part of the property is used for "own-use" activities that fall within the scope of IAS 16, the standard on property, plant and equipment and part of the property is used for activities that fall within the scope of IAS 40. A portion of a dual-use property is classified as an investment property only if the portion could be sold or leased out separately under a finance lease; in some countries the ability to sell a portion of a property is referred to as strata title or condominiumization.

For example, entity M owns an office block and uses two floors as its own office; the remaining 10 floors are leased out to tenants. In accordance with the laws in M's country, M could sell legal title to the 10 floors while retaining legal title to the other two floors. In this case the 10 floors would be classified as investment property.

In some countries the right to sell legal title to a portion of a property is not an automatic right and it is necessary first to apply to the relevant local authority for permission. In our view, the entity should be regarded as having the ability to sell legal title to a portion of a property if the process to obtain that right is relatively straightforward and procedural, rather than being subject to review whereby the chance of rejection is more than remote.

IAS 40.10 When a portion of the property could not be sold or leased out under a finance lease separately, the entire property is classified as investment property only if the portion of the property held for own-use is insignificant. "Insignificant" is not defined, but in our view, should be assessed on a property-by-property basis by reference to value and / or usable floor space. For example, an own-use portion below five per cent of the measure used generally will be insignificant.

For example, entity N uses 10 per cent of the office floor space of a building as its head office. N leases the remaining 90 per cent to tenants, but is unable to sell the tenants' space or to enter into finance leases relating solely to it. In our view, N should not classify the property as an investment property because the 10 per cent of floor space used by N is more than an insignificant portion.

The following are examples of dual-use properties illustrating:

- portions of the property that generally would be classified as investment property assuming that they could be sold or leased out under finance leases separately, subject to ancillary services being relatively insignificant (see below); and
- portions of the property that often cannot be classified as investment property because they cannot be sold or leased out under finance leases separately.

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Examples of dual-use properties	*Examples of portions that might be classified as investment property*	*Examples of portions that often cannot be classified as investment property*
Hotel complex	Separate retail premises Office block	Hotel bedrooms Restaurant facilities within the hotel complex Kiosks in the reception hall
Retail area	Separate retail premises with their own separate entrances, or a retail area within another building (e.g., a shopping mall or a hotel)	Retail concessions or franchises within a department store
Airports	Separate buildings within the airport perimeter, such as hotels, warehousing, airline office blocks, courier facilities	Retail concessions in the airport terminal

Ancillary services

IAS 40.11, 12

In many cases the owner of a property provides ancillary services to tenants. In such cases the key to identifying investment property is to decide whether the services provided are a "relatively insignificant component of the arrangement as a whole". The standard gives two examples of properties where ancillary services are provided:

- an owner-managed hotel is not an investment property because ancillary services provided are a significant component of the arrangement; and
- an office building where security and maintenance services are provided by the owner is an investment property because these ancillary services are an insignificant component of the arrangement.

IAS 40.13

Classification difficulties arise in respect of properties that fall between these two extreme examples (e.g., serviced apartments and business centres). The standard acknowledges that judgement is required in assessing whether the definition of investment property is met, and requires an entity to develop criteria that are applied consistently in making that assessment. In our view, an entity should make a decision in each case as to whether the substance of the arrangement is more like the example of the owner-managed hotel (not investment property) or the example of the office building with security and maintenance services provided by the owner (investment property). For example:

- Entity P owns serviced apartments that are located within one of its hotel complexes; tenants have full access to the hotel facilities and P provides a full daily cleaning service and room service menu. The only significant difference between these accommodations and a hotel suite is a lower price per night, based on a weekly rather than a daily rate. In our view, these serviced apartments are not investment property because they are similar to an owner-managed hotel.
- Entity Q owns serviced apartments that are located within an apartment block. Q provides security and maintenance services and offers an optional weekly cleaning and laundry service. The leases have a minimum term of three months and references generally are required. The arrangement may be similar to an office building with security and maintenance services. In our view, these serviced apartments are investment property.

A similar approach applies to classifying business centres. Some business centres provide a high level of services (such as secretarial support, teleconferencing and other computer facilities) and tenants sign relatively short-term leases or service agreements; in our view, these facilities are more like an owner-managed hotel (and not an investment property). Other business centres require the user to sign up to a minimum period and may provide only basic furnishings in addition to services such as security and maintenance; in our view, these additional services are relatively insignificant and the property would be an investment property.

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Properties managed by others

IAS 40.13, 14 When a property is operated by a third party under a management contract, it is necessary to apply judgement in assessing whether the definition of investment property is met. The standard acknowledges that the terms of management contracts vary widely, and requires an entity to develop criteria that are applied consistently in making an assessment.

IAS 40.13 The standard gives two examples of properties managed by others:

- at the one extreme, the entity's position is that of a passive investor; and
- at the other extreme, the entity simply has outsourced certain day-to-day functions and retains significant exposure to variation in cash flows.

In our view, in order to classify properties that fall between these two extremes, the relevant factors to be considered include the following:

- under the management contract, which party has the power to make the significant operating and financing decisions regarding the operations of the property. For example, which party has the power to decide:
  - hiring and firing of staff and staffing levels;
  - opening hours (if applicable);
  - terms and conditions offered to customers; and
  - products on offer;
- the calculation of the owner's return; for example:
  - a fixed or variable return based on property values is more indicative of investment property; and
  - a direct percentage of turnover or net revenue earned by the tenant is more indicative that the property is not investment property;
- the power of intervention that the owner has under the management contract. Is it greater or less than might be expected from a normal landlord / tenant relationship?
- the duration of the contract; for example, is it on an annual renewal basis with early cancellation clauses or for a much longer fixed period of time?

In our view, where a property owner is sharing substantial operating risks with the property manager, the owner is in effect participating in the delivery of goods and services. Therefore, the property is not investment property.

3.4.2 Recognition

If an entity acquires a piece of land with the intention of constructing an investment property on it, in our view, during the construction phase only the building should be accounted for as property, plant and equipment in accordance with IAS 16. The land component of the property should be classified as investment property immediately.

IAS 40.16 Investment property is recognised as an asset when, and only when:

- it is probable that the future economic benefits that are associated with the investment property will flow to this entity; and
- the cost of the investment property can be measured reliably.

3.4.3 Initial measurement

IAS 40.20 Investment property is measured initially at cost except when the asset is transferred from another balance sheet category (see 3.4.5).

IAS 40.20-22 The cost of investment property includes transaction costs and directly attributable expenditure on preparing the asset for its intended use. The principles discussed in respect of attributing cost

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to property, plant and equipment (see 3.2) apply equally to the recognition of investment property. In addition, clearly identified inefficiencies and initial operating losses should be expensed as incurred, which also is similar to property, plant and equipment (see 3.2).

IAS 40.24 Where payment is deferred, the cost of the investment property is the cash price equivalent. The issues that arise in accounting for deferred payment are similar to those in respect of property, plant and equipment (see 3.2).

IAS 40.22 When investment property is self-constructed by an entity, it is accounted for as property, plant and equipment (see 3.2) until construction or development is complete. Generally this would mean that during the construction or development phase the property is accounted for using the cost model under IAS 16. The transfer of the completed property to investment property and the redevelopment of existing investment property is discussed below under 3.4.6.

3.4.4 Subsequent measurement

IAS 40.30 Subsequent to initial recognition an entity must make an accounting policy election, which should be applied consistently, to either:

- measure all investment property based on the fair value model, subject to limited exceptions that are discussed below; or
- measure all investment property based on the cost model.

IAS 40.31 The standard implies a preference for measuring investment property at fair value, noting that it will be very difficult to justify a voluntary change in accounting policy from the fair value model to the cost basis of measurement. Entities adopting the cost model are required to disclose the fair value on the same basis as those adopting the fair value model.

Fair value model

General requirements

IAS 40.33-52 If an entity chooses to measure investment property using the fair value model, it must measure the property at fair value at each balance sheet date, with changes in fair value recognised in the income statement. Considerable guidance is provided on determining the fair value of investment property, which generally involves consideration of:

- the actual current market for that type of property in that type of location at a specific date (i.e., the balance sheet date) and current market expectations;
- rental income from current leases and market expectations regarding possible future lease terms;
- hypothetical sellers and buyers, who are reasonably informed about the current market and who are motivated, but not compelled, to transact in that market on an arm's length basis; and
- investor expectations, for example, when valuation has been done by independent valuers in the past.

IAS 40.20, 37 Estimated transaction costs are not deducted in determining fair value. This means that, when the property market remains flat or falls between the acquisition date and the date of revaluation, the capitalised transaction costs included in the initial cost of a property will be recognised as a loss in the income statement.

For example, entity R acquires an investment property for 300 and incurs transaction costs of 5. Therefore, the initial carrying amount of the property is 305. At the balance sheet date there has been no movement in the market and the fair value of the property is 300. The loss of 5, which represents the transaction costs on acquisition, is recognised in the income statement.

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IAS 40.32 An entity is encouraged, but is not required to have valuations carried out by an independent valuer who holds a recognised and relevant professional qualification, and who has recent experience in the location and category of investment property being valued. In our experience entities take into account the following factors when deciding whether or not to engage an independent valuer:

- the materiality of the assets to the balance sheet;
- the degree of fluctuation in the market;
- the ease with which a non-expert can make a reasonable estimate of fair value from publicly available information (e.g., information on recent transactions involving comparable properties); and
- whether the entity employs staff already with relevant qualifications.

For example, when an entity has material investment property, but the property market is reasonably stable and there are frequent transactions in comparable properties for which information is readily available, the entity may adopt a practice of engaging independent property experts only every three years, and estimating changes in fair value by other methods in the intervening periods. Note that such an approach is not an accounting policy in itself, and if, for example, the market has been unusually volatile in the last accounting period, or has become less liquid, it may be necessary to obtain additional valuation information from professional valuers.

IAS 40.46(c) When there is no freely available information on an active market in comparable properties in similar locations, it may be possible to apply discounted cash flow techniques to estimate fair value, if reliable estimates of future cash flows are available.

It may be necessary to engage the services of a professional valuer to assist with measuring fair values, especially when there is no freely available information about comparable properties. This is not required specifically by IFRSs, but without the knowledge of an expert it will be difficult to meet the requirements of the standard.

Exemption from fair value

IAS 40.53 In exceptional cases there will be clear evidence on initial recognition of a particular investment property that its fair value cannot be determined reliably on a continuing basis. In such cases the property in question is measured using the cost model in accordance with IAS 16 (see 3.2), except that the residual value is deemed to be zero in all cases. The exemption applies only when comparable market transactions are infrequent and alternative estimates of fair value (e.g., based on discounted cash flow projections) are not available.

IAS 40.55 An assessment of whether the exemption applies is made only at the time that the investment property is recognised initially (following either acquisition or transfer from another balance sheet category). The exemption cannot be used after initial recognition, even if comparable market transactions become less frequent and alternative estimates of fair value become less readily available.

IAS 40.53 Once the exemption is applied, the property continues to be measured in accordance with IAS 16 until its disposal.

Cost model

IAS 40.56 If an entity chooses to measure investment property using the cost model, the property is accounted for in accordance with the cost model for property, plant and equipment in IAS 16 (i.e., at cost less accumulated depreciation (see 3.2) and less any accumulated impairment losses (see 3.9)). However, the property continues to be classified as investment property in the balance sheet.

IAS 40.79 If an entity adopts the cost model for measuring investment property in its financial statements, the fair value of investment property still must be disclosed on the same basis as under the fair

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value model. In this regard the guidance above in respect of the determination of fair value applies, including the exemptions from fair value measurement.

3.4.5 Subsequent expenditure

IAS 40.22 (2000)

Expenditure incurred subsequent to the completion or acquisition of an investment property is capitalised only when it is probable that it will give rise to future economic benefits in excess of the originally assessed standard of performance of the asset. Expenditure incurred simply to restore or maintain the level of future economic benefits is expensed as incurred#.

Forthcoming requirements

IAS 40.16-19

The revised standard requires that parts of investment properties acquired through replacement are capitalised and included in the carrying amount of the investment property if the general asset recognition criteria are met. The carrying amount of the part replaced is derecognised. Costs of day-to-day servicing are not included in the investment property's carrying value. This is consistent with similar changes made to IAS 16 in respect of property, plant and equipment (see 3.2).

The issues that arise in accounting for subsequent expenditure are similar to those in respect of property, plant and equipment (see 3.2).

3.4.6 Transfers to or from investment property

Timing of transfers

IAS 40.57, 58

Although intention plays a key role in the initial classification of property (see 3.4.1), the subsequent reclassification of property is based on an actual change in use rather than on changes in an entity's intentions.

IAS 40.58

For example, entity S owns a retail site that is an investment property. S decides to modernise the site and then to sell it. The investment property is transferred to inventory at the date that the redevelopment of the site commences as this evidences the change in use. However, a decision to dispose of an investment property without redevelopment does not result in it being reclassified as inventory. The standard requires specifically that the property should continue to be classified as investment property until the time of disposal.

IAS 40.57, 58

When an investment property is developed or constructed by the entity itself, it is transferred from property, plant and equipment to investment property at the end of construction or development. In our view, an owner-occupied property that is redeveloped into investment property also is transferred to investment property at the end of redevelopment.

IAS 40.57

In order to reclassify inventories to investment property, the change in use has to be evidenced by the commencement of an operating lease to another party. In some cases a property (or a part of a property) classified as inventory (see 3.7) is leased out temporarily while the entity searches for a purchaser. In our view, the commencement of such an operating lease, solely of itself, does not require the entity to transfer the property to investment property provided that the property continues to be held for sale in the ordinary course of business. Any rental income must be incidental to such sale.

Measurement of transfers

Cost model

IAS 40.59

If an entity chooses to measure investment property using the cost model, transfers to and from investment property do not alter the carrying amount of the property. Therefore, revaluations recognised for property, plant and equipment carried at fair value under the allowed alternative treatment in IAS 16 (see 3.2) would not be reversed when the property is transferred to investment property.

The standard does not state specifically whether the property's carrying amount should be brought up to date under its current policy immediately before the transfer. In our view, a restatement to bring

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the property's carrying amount up to date is required if the effect would be material to the way the results for the period are presented in the income statement.

For example, entity T has a property classified as inventory. Some time after acquisition, management decides to hold the property indefinitely because the market currently is depressed, and has leased out the property to another party under an operating lease. The net realisable value of the property is 450, which is lower than its cost of 480. In our view, T should write-down the property to 450 prior to transferring it to investment property and the loss of 30 should be presented in the income statement in the same line as other inventory write-downs.

IAS 16.41, 40.62 IAS 40 is silent on the treatment of an existing revaluation reserve when revalued property is transferred from property, plant and equipment to investment property, where it will be measured under the cost model. In our view, any revaluation reserve accumulated while the property was accounted for under IAS 16 should be accounted for in accordance with that standard (i.e., the reserve *may* be transferred to retained earnings as the amount is realised either through higher depreciation charges while the asset is being used or on disposal). Issues that arise in respect of this treatment are discussed in 3.2.

Fair value model

IAS 40.61-65 A transfer from another balance sheet category to investment property is made at fair value. The treatment of the gain or loss on revaluation depends on whether the property was previously held for own-use, or not.

IAS 40.61, 62 When the property previously was held for use, the property should be accounted for as property, plant and equipment up to the date of the change in use. Any difference at the date of the change in use between the carrying amount of the property and its fair value should be recognised in profit or loss, or equity, in accordance with the requirements of IAS 16 for revaluations.

IAS 40.63-65 When the property is self-constructed investment property that was under construction previously or inventory that is being transferred to investment property, the gain or loss on revaluation, based on the asset's carrying amount at the date of transfer, is recognised in the income statement.

IAS 40 is silent on where any gain or loss arising at the point of transfer should be recognised. In our view:

- any gain or loss on property previously classified as inventory should be included in the same line as other gains or losses on inventory; and
- any gain or loss on self-constructed investment property should be included in the same line as other gains or losses on the disposal of property, plant and equipment.

In both cases the gain or loss should be identified separately if material (see 4.1).

IAS 40.60 When a property is transferred from investment property (whether to own-use properties or to inventories), the transfer is accounted for at fair value. The fair value at the date of transfer then is deemed to be the property's cost for subsequent accounting under IAS 2 or IAS 16 (see 3.7 and 3.2, respectively). Any difference between the carrying amount of the property prior to transfer and its fair value on the date of transfer is recognised in the income statement in the same way as any other change in the fair value of investment property.

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3.4.7 Redevelopment

IAS 40.58 When an entity redevelops an existing investment property, the property is not transferred out of investment property during redevelopment. This means that an investment property undergoing redevelopment would continue to be measured at depreciated cost or at fair value (depending on the entity's accounting policy).

However, consideration should be given to whether any of the property has been disposed of during the course of redevelopment. For example, significant items of equipment installed in the building, or even the building itself, may have been scrapped. In our view, any such disposals should be accounted for as follows:

- When investment property is measured under the cost model, components of the property should be accounted for as separate assets in accordance with IAS 16 (see 3.2). Accordingly such components should be written off as disposals.
- When an investment property is measured at fair value, information may not exist to enable the entity to account for the disposals separately. In our view, it is acceptable to include the disposals as part of the change in fair value.

3.4.8 Disposals

IAS 40.69 The gain or loss on disposal of investment property is measured as the difference between the net disposal proceeds and the carrying amount of the property (unless the transaction is a sale and leaseback – see 5.1). The standard gives no guidance on the meaning of "net" in this context. In our view, it should be determined in the same manner as for property, plant and equipment (see 3.2).

Although not stated explicitly in the standard, when investment property is accounted for based on the fair value model, in our view the carrying amount on disposal is the carrying amount at the date of the last published balance sheet (whether annual or interim), and should not include any subsequent interim valuation.

For example, entity V measures investment property at fair value. V's last published balance sheet was as at the end of its half-year interim period, 30 September 2003. The carrying amount of one particular retail site was 500 at the date. On 28 February 2004 V obtained an independent valuer's report that stated that the fair value of the retail site had dropped to 470, and this was recorded in V's management accounts. On 31 March 2004 the property was sold for 490. In our view, a loss on disposal of 10 should be recognised in the income statement. We do not believe that it would be appropriate for the income statement to include a loss of 30 as part of the line including all investment property fair value changes, and a profit of 20 on disposal presented separately.

IAS 40.70 When payment is deferred, the selling price of the investment property is the cash price equivalent for the property (i.e., the amount that the entity would be prepared to accept if settlement were immediate). In almost all cases the cash price equivalent will not differ significantly from the measurement of the receivable under IAS 39, which would require the gross cash flows receivable from the buyer to be discounted using a market rate of interest (see 3.6). When a significant difference does exist in a transaction, in our view the requirements of IAS 40 should apply because the standard addresses deferred consideration specifically. Under IAS 40 the difference between the cash price equivalent and the gross cash flows is recognised as interest income over the period until payment, using the effective interest method.

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3.4.9 Presentation and disclosure

IAS 1.68 Investment property is presented separately on the face of the balance sheet.

IAS 40.74-79 Since IAS 40 makes no reference to making disclosures on a class-by-class basis, it could be assumed that the minimum requirement is to make the disclosures on an aggregate basis for the whole investment property portfolio. In our view, when investment property represents a significant portion of the assets it is preferable to disclose additional analysis, for example:

- analysing the portfolio into different types of investment property, such as retail, offices, manufacturing and residential; and
- identifying separately any properties currently under redevelopment, vacant, and / or whose use is undetermined and / or that are intended for sale.

3.4.10 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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3.5 Investments in associates and joint ventures

(IAS 28, IAS 31, SIC–13)

Overview

- **The definition of an associate is based on the *ability* to exercise significant influence, which is the *power* to participate in the financial and operating policies of an entity.**
- **There is a rebuttable presumption of significant influence if an entity holds 20 to 50 per cent of the voting rights of another entity.**
- **Potential voting rights that are exercisable currently are taken into account in assessing significant influence.**
- **A joint venture is an entity, asset or operation that is subject to contractually established joint control.**
- **Associates are accounted for using the equity method in the consolidated financial statements.**
- **Jointly controlled entities may be accounted for either by proportionate consolidation or using the equity method.**
- **Equity accounting or proportionate consolidation is not applied if the investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor, or if the investment is acquired and held exclusively for disposal in the near future#.**
- **Entities excluded from proportional consolidation or equity accounting are treated as financial assets.**
- **An associate's or joint venture's accounting policies should be consistent with those of its investor, unless impracticable#.**
- **When an associate or a joint venture accounted for under the equity method incurs losses, the carrying amount of the investor's equity investment is reduced, but not below zero. At that point, further losses are recognised by the investor only to the extent that the investor has an obligation to fund losses.**
- **Unrealised profits and losses on transactions with associates or joint ventures are eliminated to the extent of the investor's interest in the investee.**
- **Venture capitalists must apply the equity method for all associates, and must account for jointly controlled entities by either proportionate consolidation or using the equity method#.**

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Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 28 *Investments in Associates* and IAS 31 *Investments in Joint Ventures*. The revised standards are effective for account periods beginning on or after 1 January 2005. Early adoption is encouraged. Where an existing requirements is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standards:

- introduce a scope exclusion for investments in associates or joint ventures by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds;
- these investors may elect not to apply equity accounting provided that the investments in associates and joint ventures are classified as held for trading and accounted for under IAS 39 *Financial Instruments: Recognition and Measurement* with changes in fair value recognised in the income statement in the period of the change;
- prohibit use of the equity method of accounting by an investor in its separate financial statements; and
- modify the guidance previously in SIC–20 *Equity Accounting Method – Recognition of Losses* by including other long-term interests that form part of the investor's net investment in the associate when recognising an investor's share of losses. Interests to be considered do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists (e.g., secured loans).

3.5.1 Associates

IAS 28.2 An associate is an entity over which an investor has *significant influence*.

Significant influence

IAS 28.2 Significant influence is the *power* to participate in an entity's financial and operating policy decisions.

Significant influence may exist over an entity that is controlled by another party. More than one party may have significant influence over a single entity.

Assessing significant influence

Voting rights

IAS 28.6 Significant influence is presumed to exist when an investor holds between 20 and 50 per cent of the voting power of another entity. Conversely it is presumed that significant influence does not exist with a holding of less than 20 per cent. These presumptions may be overcome in circumstances when an ability, or lack of ability, to exercise significant influence can be demonstrated clearly.

Qualitative factors

IAS 28.7 The standard states that the following factors may indicate significant influence:

- representation on the board of directors or equivalent governing body of the investee;
- participation in policy-making processes;
- material transactions between the investor and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

In our view, additional factors that may indicate significant influence include:

- existence of a right of veto over significant decisions;
- lack of concentration of other shareholdings;
- influence over decisions concerning dividend or reinvestment policy; or
- guarantees of indebtedness, extensions of credit, ownership of warrants, debt obligations or other securities.

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A single factor in isolation does not necessarily indicate significant influence. For instance, providing management services to an entity does not in itself result in the entity being an associate. Similarly, entering into material transactions with an entity does not necessarily give rise to significant influence over that entity. On the other hand meaningful representation on the governing body of an entity generally indicates significant influence. Therefore, the analysis requires judgement considering all the facts and circumstances.

The following are examples of the analysis for some typical arrangements:

- C is a construction company. P, Q and R are paper producers. P, Q and R enter into a partnership arrangement with C. Under the terms of the agreement C will construct a paper mill. P, Q and R will supply raw materials to the partnership. P is the operations manager and is responsible for operating the mill. P, Q and R each have a 30 per cent interest in the partnership. C has a 10 per cent interest and can choose to sell this interest once the paper mill is operating successfully. A bank provides financing. The final product will be sold to third party customers. Any profit from the sale of the final product will be distributed amongst the partners in proportion to their ownership interests. It appears that P, Q and R each have significant influence over the partnership. If the partnership agreement gives C the ability to significantly influence policy decisions then the partnership also would be an associate of C.
- B manufactures bricks. S and T each hold 50 per cent of B's shares. S supplied the brick-making technology and in return receives a license fee equal to 10 per cent of gross sales. T operates the factories and handles the manufacturing, selling and administrative functions in return for an annual management fee. S and T each have two seats on B's six-person board of directors. S and T both appear to have significant influence over B.

Ability to exercise versus actual exercise of significant influence

IAS 28.6

In determining whether an entity has significant influence over another entity, the focus is on the *ability* to exercise significant influence. It does not matter whether significant influence actually is exercised or not. In this respect assessing whether the investor has the ability to exercise significant influence is similar to the assessment of whether an investor has the power to control an entity. See 2.5 for additional guidance and examples illustrating this assessment process.

Indirect holdings

IAS 28.6

In assessing whether voting rights give rise to significant influence it is necessary to consider both direct holdings and holdings of subsidiaries (see 2.5). Holdings of associates and joint ventures are not included in this evaluation.

Potential voting rights

IAS 28.8

In assessing significant influence, the impact of potential voting rights that are exercisable currently (both those held by the entity and by other parties) are taken into account. Potential voting rights include warrants, call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power. They also include call options which are currently out-of-the-money. See 2.5 for more guidance on this assessment process.

3.5.2 Joint ventures

IAS 31.3

The definition of a joint venture has two aspects, both of which must be present in order to conclude that an entity is a joint venture rather than an associate or subsidiary:

- a *contractual arrangement* whereby two or more parties undertake an economic activity…
- …that is subject to *joint control*.

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Contractual arrangement

IAS 31.9 The existence of a *contractual* arrangement is a key aspect of the definition of a joint venture. An entity that has its shares evenly split amongst its shareholders, for example, one with two shareholders each having a 50 per cent interest, or four shareholders each having a 25 per cent interest, is not a joint venture unless there is a contractual arrangement that establishes joint control.

IAS 31.10 The contractual arrangement between the venturers can take many forms. It could be a contract signed by the venturers, minutes of discussions between the venturers, or the joint venture arrangement could be incorporated in the articles or by-laws of a jointly controlled entity. The form of the contractual arrangement also may depend on the requirements of the local laws and regulations.

It is uncommon for an entity whose shares are publicly traded to be subject to contractually established joint control.

Joint control

IAS 31.11 Joint control exists where no venturer can, in substance, control a joint venture unilaterally.

Joint control does not require a 50:50 interest. Joint control has its origin in the contractual agreement and therefore can be created between more than two venturers and with various proportionate holdings. For example, three parties with holdings in the ratio of 40:30:30 may exercise joint control if there is a contractual agreement that requires unanimous consent for all key decisions. However, in our view, if the holdings are significantly different (e.g., if one party holds 75 per cent and another party holds 25 per cent) it is unlikely that joint control exists.

Joint control also may exist between two or more venturers when another entity has an interest that does not give it joint control, for example, when the respective interests are 45:45:10.

The distinguishing feature of joint ventures normally is that decisions in all areas essential to the accomplishment of the goals of the joint ventures require the consent of the venturers as provided by the agreement. However, this does not preclude a joint venture from existing where some decisions require the consent of a majority of the venturers and only certain more significant decisions require consent (or, at least, lack of dissent) by all parties.

Assessing joint control

Factors that may be relevant in assessing joint control include:

- The rights of each of the parties. To convey joint control, rights should be over substantive operating decisions, for example, to approve annual business plans; to select, terminate, and set the compensation of management responsible for implementing the investee's policies and procedures; or to establish operating and capital decisions of the investee (including budgets), in the ordinary course of business. A right that is protective, for example, to approve decisions to issue shares, would not be an indication that joint control exists.
- The terms of shareholder agreements. If there are clauses in the shareholder agreements or financial arrangements that give additional rights to one of the parties this may indicate that the party with the additional rights has control (see 2.5).
- How disputes between the parties are resolved. For joint control, dispute resolution procedures should be neutral and not favour one of the parties, for example, a mutually agreed independent arbitrator should be used.
- The termination provisions. Consider how termination is initiated and whether any party has an advantage.
- Subsequent transactions, for example, a sell-off by one of the parties, that are contemplated when the joint venture is set up.

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- The governance structures. It is important to understand the roles and responsibilities of any shareholders' committees, including the role of the supervisory board, executive board or steering committees (see 2.5).

As an intermediate step in a business combination, the buyer and seller may exercise joint control over an entity. In our view, in these cases it is necessary to consider the overall economic effect of all the transactions related to the business combination as a whole. If these facts and circumstances indicate that the joint control is not substantive, for example, because the joint control is for too short a period to have any real economic effect, the entity should not be treated as a joint venture. See 2.6 for a discussion of accounting for business combinations.

Agreeing to act in the best interests of another party does not in itself establish joint control. For example, R and S enter into an affiliation arrangement to develop and market a new product. R and S each have a 50 per cent interest in a new entity T. R knows the local market and therefore is responsible for the operation and management of T. R agrees to act in the best interests of both parties when determining the financial and operating policies to be adopted by T. Profits will be distributed equally to both parties after deducting a fee paid to R for the operational management work. Unless S has other rights that enable it to block policy decisions made by R, R has control over the financial and operating policies of T. Therefore, T is a subsidiary of R and not a joint venture.

IAS 31.24 In assessing whether an entity is subject to joint control, it is necessary to consider the rights of each venturer individually, rather than a group of shareholders that may act together. For example, K is a public entity. The shares of K are held 50 per cent by L and 50 per cent by members of the public. L appoints four of the eight directors of the board of K. Decisions are made based on a majority vote. Therefore, the public shareholders as a group have the ability to block any decisions made by L. However, this does not make K a joint venture, as each of the shareholders individually does not have joint control.

Management control

IAS 31.12 Joint control must be assessed in terms of the ability to control the key financial and operating policies. One party may be the operator or manager of a joint venture, as long as all parties agree key operating and financial policies collectively and the non-managing parties have the power to ensure these are followed.

3.5.3 Jointly controlled entities

IAS 31.24 When a joint venture activity is carried on through a separate entity (e.g., a corporation or partnership), it is known as a "jointly controlled entity". This is the most common form of joint venture.

3.5.4 Jointly controlled assets and operations

IAS 31.18 "Jointly controlled assets" arise from an arrangement that is a joint venture carried on with assets that are controlled jointly (whether or not owned jointly), but not through a separate entity. Examples of jointly controlled assets include:

- Two oil producers sharing the use of a pipeline to transport oil. Both parties bear an agreed proportion of the operating expenses.
- Four parties entering into an arrangement to jointly control an investment portfolio. The joint venture is evidenced by a contract, but no separate entity is formed.

IAS 31.13 A "jointly controlled operation" is a joint venture carried on by each venturer using its own assets in pursuit of the joint operation. For example:

- Three aircraft charter companies agree to operate a charter route jointly, using their own aircraft and sharing sales revenue.

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- Four construction companies agree to act as a consortium to construct a hotel for a customer. One contract is signed between the customer and the members of the consortium. All four entities are party to the contract as the consortium is not a legal entity.

3.5.5 Associates and joint ventures accounted for as financial assets or classified as held for sale

IAS 28.8 (2000), 31.35 (2000)

Neither the equity method nor proportionate consolidation is applied to associates or jointly controlled entities when:

- the investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor; or
- control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future#.

Such investments are accounted for as financial assets (see 3.6).

These exemptions are the same as those that apply for investments in subsidiaries; see 2.5 for additional guidance.

Forthcoming requirements

IAS 28, 31

The revised standards contain no exemption from equity accounting or proportionate consolidation for an associate or joint venture that operates under severe long-term restrictions. Instead restrictions on the ability to transfer funds to the investor should be considered when assessing whether joint control or significant influence exists.

The revised standards also amend the exemption regarding temporary control to specify that subsequent disposal generally is expected within 12 months from acquisition and that the acquirer should be seeking a buyer actively.

IFRS 5.38-40

However, this exception was revised again in March 2004 by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. When applying IFRS 5, an investment acquired exclusively with a view to its subsequent disposal in the near future is not equity accounted or proportionately consolidated. Instead, the investment is classified as held for sale and measured and presented in accordance with IFRS 5 (see 5.4A).

Held for sale

Forthcoming requirements

IFRS 5.15

In March 2004 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* amended the scope of IAS 28 and IAS 31. When an existing investment in an associate or joint venture is classified as held for sale, the investor ceases to equity account or proportionately consolidate the investee. Instead, the investment is classified as held for sale and measured and presented in accordance with IFRS 5 (see 5.4A).

3.5.6 Venture capital entities

Venture capital entities and unit trusts are not exempt from the requirements to apply equity accounting or proportionate consolidation when they have significant influence or joint control. Thus all associates and joint ventures must be accounted for using the equity method or proportionate consolidation, subject to the general exemptions discussed in 3.5.5#.

Venture capitalists often hold investment stakes of between 20 and 50 per cent. These investments often meet the definition of associates and therefore would be required to be accounted for using the equity method unless there is clear evidence that there is no ability to exercise significant influence (e.g., a shareholders' agreement restricting the investor's powers), or unless one of the general exemptions in 3.5.5 apply.

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Forthcoming requirements

IAS 28.1, 31.1 The scope of IAS 28 and IAS 31 was amended in 2003 to exclude investments in associates and in joint controlled entities held by venture capitalists and similar entities provided that the investments are classified as held for trading and measured at fair value with all changes in fair value recognised in the income statement in accordance with IAS 39 (see 3.6).

3.5.7 Accounting periods and policies

Unless otherwise noted, all comments regarding associates apply also to joint ventures accounted for using the equity method.

IAS 28.24 Unless it is impracticable, associates' financial statements used for the purposes of applying the equity method should be drawn up for the same accounting period as that of the investor. When different periods are used the length of reporting periods and gap between reporting periods should be consistent from period to period#.

Forthcoming requirements

IAS 28.25 Under the revised standard, the difference between the reporting date and the date of the financial statements of an associate used when applying the equity method may not exceed three months.

IAS 28.24 When different reporting periods are used for the purpose of applying the equity method, adjustments are made for the effects of any significant events or transactions that occur between the two reporting dates.

IAS 28.20 (2000) For the purpose of applying the equity method, the financial information of all associates should be prepared on the basis of IFRSs. When practical, the investor's accounting policies should be applied. If this is not practical and uniform accounting policies are not used, this fact should be disclosed#.

Forthcoming requirements

IAS 28.26 The revised standard requires that uniform accounting policies are used in preparing the investor's financial statements, with no exception. Accordingly, when an associate applies different policies in its own financial statements, adjustments are required to conform to the investor's accounting policies.

Availability of information

It is acceptable to use either the most recently published information or the most recent management accounts of an associate for the purpose of applying equity accounting. Difficulty in obtaining financial information needed to apply the equity method is not grounds for exemption from equity accounting. It is presumed that the investor, by virtue of its ability to exercise significant influence, is able to obtain the necessary information from associates.

3.5.8 Accounting for associates

Unless otherwise noted, all comments regarding associates apply also to joint ventures accounted for using the equity method.

IAS 28.11 Associates are accounted for in the consolidated financial statements using the equity method. Under the equity method:

- the investment is stated as one line item at cost plus the investor's share of retained post-acquisition profits and other changes in net assets;
- cost includes the goodwill arising on the acquisition;
- the investor's share of profits or losses of the associate is presented as a single item in the income statement;
- any distributions received from the associate reduce the balance sheet carrying amount; and
- the investor's share of any gains and losses that are recognised by the investee directly in equity, for example, revaluation surpluses as well as other changes in equity of the associate, are

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recognised directly in the investor's equity. Such changes include revaluations of investments and foreign exchange translation differences.

IAS 28.20, 22

The general procedures applicable to consolidation and accounting for an acquisition apply. Therefore, for example, inter-entity transactions are eliminated to the extent of the investor's interest. These general consolidation principles are addressed in 2.5. Issues are addressed below only to the extent specific issues arise in the application of these principles to associates.

Goodwill and fair value adjustments

IAS 28.17 (2000)

On the date of acquisition of an associate, fair values must be attributed to the associate's identifiable assets and liabilities as explained in 2.6. Any difference between the investor's share of the fair values of the acquired net assets and the purchase price is goodwill or negative goodwill. Goodwill (or negative goodwill) arising on acquisition of an associate is accounted for in the same way as goodwill (or negative goodwill) arising on acquisition of a subsidiary (see 2.6).

In our view, the goodwill or negative goodwill should be included in the carrying amount of the investment in the associate and should not be shown separately. Amortisation of the goodwill or negative goodwill recognised is shown as an adjustment to the profit or loss from the associate in the profit or loss from associates line item#.

Forthcoming requirements

IAS 28.23, IFRS 3.55

The revised standard confirms that goodwill should be included in the carrying amount of the investment in the associate and not shown separately. Goodwill is not amortised and therefore amortisation is not included in the determination of the investor's share of the associate's profit or losses.

IAS 28.23

Negative goodwill is excluded from the carrying amount of the investment and is included as income to measure the investor's share of the associate's income statement in the period in which the investment is acquired.

IAS 28.23

The investor's share of depreciation charges to be included in the income from associates line item in the investor's financial statements reflect any fair value adjustments for depreciable assets at the date of acquisition of the investment in the associate. The fair value adjustment is made only for the proportion of net assets acquired.

Percentage attributable to the investor

In some cases the economic interests of investors will not equal their shareholding (voting interest). For example, an entity may control 30 per cent of the voting power of an associate, but have only a 20 per cent economic interest in the profits and net assets of the entity. In these cases the investor should account for the 20 per cent economic interest.

Indirect holdings

Shareholdings of the parent and all subsidiaries are taken into account in applying the equity method. But shareholdings of other associates and joint ventures are not considered.

For example, H has a 50 per cent shareholding in joint venture J and a 25 per cent holding in associate A. J also holds 10 per cent of the share capital of A.

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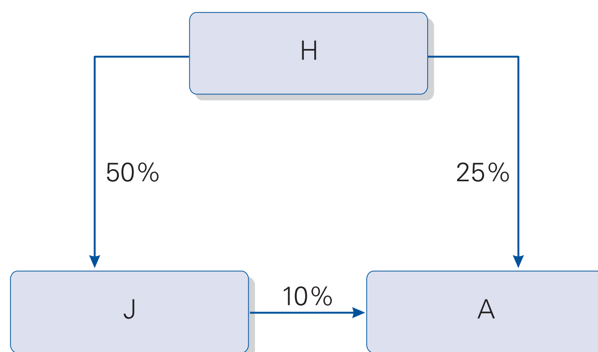

A reports a loss of 40, but pays a dividend from accumulated profits of 200. H will apply the equity method of accounting for its 25 per cent interest in A and will not apply the equity method of accounting to the additional interest (effectively five per cent) held through J. Therefore, ignoring goodwill amortisation and assuming no impairment, H will include its share of A's loss of 10 (25 per cent x 40). H also will reduce the carrying amount of its investment in A by the dividends received of 50. J elects to account, in its separate financial statements, for its interest in A under the cost method. Accordingly, in accounting for its interest in J, H will include J's share of the dividend received from A of 10 (50 per cent x 10 per cent x 200).

This is different to the treatment that would result from H having taken into account J's 10 per cent holding and therefore treating A as a 30 per cent associate (25 per cent + (50 per cent of 10 per cent)). Under this method the share of losses would have been 12 (30 per cent x 40) and the amount applied against the carrying value of A in respect of the dividends received would have been 60 (30 per cent x 200). In our view, this approach is not appropriate because H does not fully control J.

	IAS 28 method	*If all equity accounted*
Share of loss of A	(10)	(12)
Dividends received from A	(50)	(60)
Decrease in carrying amount of investment in A	(60)	(72)
Share of dividend received by J from A recognised in the income statement	10	-

An issue may arise when an entity acquires shares in an associate for strategic or trading purposes. For example, N is a wholly owned subsidiary of M. M has a 30 per cent interest in O, an associate. N has significant investing activities and as part of these activities acquires a three per cent interest in O. The issue is whether M's three per cent holding may be treated as an investment under IAS 39 rather than accounted for under the equity method in the consolidated financial statements. In our view, because IAS 28 requires direct and indirect holdings to be evaluated in classifying an investment as an associate and in accounting for the investment, it would not be acceptable to apply IAS 39 to the investment in the consolidated financial statements. M's three per cent interest should be accounted for using the equity method.

Potential voting rights

IAS 28.12

Although an investor may have taken into account potential voting rights when considering whether it has significant influence (see 3.5.1), the share of profits or losses or changes in equity recorded under the equity method are based on current ownership interests. For example, assume that G has significant influence over H as a result of a 15 per cent shareholding in H and presently exercisable options to acquire a further 20 per cent for a fixed price. G would continue to account for 15 per cent of H using the equity method. The options would be accounted for as derivatives under IAS 39 (see 3.6). G would account for a 35 per cent interest in H only if and when it exercises the options.

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Effective date

An investment in an associate is accounted for using the equity method from the date on which the investor has the power to exert significant influence over the associate.

Transactions with associates

IAS 28.20, 22

Unrealised profits on transactions with associates are eliminated to the extent of the investor's interest in the associate, regardless of whether the unearned profit is in the investor, a subsidiary in the same group as the investor, or the associate. Unrealised losses are eliminated in the same way, except to the extent that the underlying asset is impaired.

The following simple example illustrates the elimination in a "downstream" sale of inventory by the investor to a 20 per cent associate:

	Investor	*Associate*
Cost of inventory	50	150
Selling price of inventory	150	Not yet sold
Profit related to the transaction	100	0

The accounting entry required to eliminate the investor's 20 per cent interest in this transaction is as follows:

		Debit	*Credit*
Revenue	150 x 20%	30	
Cost of sales	50 x 20%		10
Investment in associate	100 x 20%		20

The credit is recorded against the carrying amount of the investment in the associate and not against inventory because the inventory is an asset of the associate, included in the investment in associate line item.

The following example is the same as above except that the 20 per cent associate makes an "upstream" sale of inventory to the investor:

	Investor	*Associate*
Cost of inventory	150	50
Selling price of inventory	Not yet sold	150
Profit related to the transaction	100 x 20% = 20	100

The investor's share of earnings from the associate will include 20 which represents the investor's share of the associate's profit on the transaction. This unrealised profit must be eliminated. However, IFRSs do not specify whether the elimination should be presented as a reduction in the investment in the associate or as a reduction in the underlying asset (e.g., inventory). In our view, either approach is acceptable, and we recommend disclosing the method adopted as an accounting policy note if significant. The accounting entry is as follows:

	Debit	*Credit*
Income from associate	20	
Investment in associate *or* inventory		20

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Elimination of balances

IAS 28.22

IFRSs only require elimination of unrealised profits or losses on transactions with associates. Balances such as receivables or payables and deposits or loans to or from associates are not eliminated when applying the equity method.

Elimination of interest income or expense

Elimination of interest income or expense arising on balances with associates is not addressed specifically in IFRSs. In our view, elimination is appropriate if the effect is material. Elimination may have no effect on the net profit of the investor – impacting only the split between financing costs and equity accounted earnings. Alternatively, if one of the parties has capitalised the interest (see 4.6) the amount recognised in the income statements of the parties would be different and the effect of elimination may be more significant.

Sale of a subsidiary to an associate

In our view, the principles for elimination of transactions with associates apply equally if an investor sells a subsidiary to an associate.

For example, assume P sells its wholly owned subsidiary S to its 30 per cent associate A. The carrying amount of the net assets of S in P's financial statements at the date of the sale is 5,500. The selling price is 9,000. Therefore, P initially records a profit on disposal of 3,500.

In our view, it is not appropriate for P to recognise the full profit on the disposal of S in its consolidated financial statements because P still has a 30 per cent interest in S, through A. Therefore, P should eliminate 30 per cent of the profit recognised on the disposal of S against the carrying amount of the investment in A.

The following shows the accounting entries necessary for P to record the transaction and the subsequent elimination:

		Debit	*Credit*
Cash		9,000	
Net assets of S			5,500
Profit on disposal			3,500
To record the transaction			
Profit on disposal	3,500 x 30%	1,050	
Investment in A			1,050
To record the elimination of the unrealised profit			

The amount included in the carrying amount of A in respect of the net assets of S in P's consolidated financial statements, following the elimination, is 1,650 (9,000 x 30 per cent - 1,050). This corresponds to the carrying amounts of the net assets of S in P's financial statements before the disposal (1,650, or 30 per cent of 5,500).

Transactions between associates

IAS 28.20, 22

IFRSs are silent on whether unrealised profits or losses on a transaction between two associates should be eliminated. There is a conceptual argument to suggest that some of the profit should be eliminated (determined by multiplying the investor's interest in the first associate by its interest in the second associate), but, in our view, this is not required.

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Preference shares

IAS 28.28

If an associate has issued cumulative preferred shares that are classified as equity, before applying the equity method the investor should reduce the profit or loss of the associate by the amount of any dividends payable on the preference shares, whether or not these dividends have been declared.

Losses

IAS 28.29, 30

The investor's share of losses of an associate is recognised until the carrying amount of the investor's equity interest in the associate is reduced to zero.

SIC 20.5-9 (1999)

For the purpose of this calculation, the equity interest in the associate includes the carrying amount of the investment under the equity method and the amount of any loans or other balances that provide unlimited rights of participation in profits or losses and a residual equity interest in the associate#.

Forthcoming requirements

IAS 28.29

The revised standard clarifies that an investor recognises its share of losses of an associate until both its equity investment and other long-term interests (e.g., loans), which are in substance part of the net investment, have been reduced to zero.

IAS 28.31-33

IAS 39 should be applied to determine whether there are any indicators of impairment in respect of any remaining net investment. Any impairment loss is measured in accordance with IAS 36 (see 3.9).

IAS 28.29, 30

A liability is recognised only to the extent that the investor has an obligation to fund the associate's operations. Any interests in the investee in addition to the equity investment are evaluated for impairment in terms of the impairment requirements for financial instruments (see 3.6).

The following example illustrates the application of this principle. A owns 40 per cent of the shares in B. B has negative equity of 200. Therefore, A's share of the equity of B is -80 (40 per cent x -200). However, A is not committed to finance the losses of B and has not provided any guarantees of B's obligations. Therefore, A will measure its investment B at zero. In addition, A will consider the recoverability of any loan it has made to B in accordance with the impairment requirements for loans (see 3.6).

3.5.9 Accounting for associates in unconsolidated financial statements

IAS 28.13

There is no requirement for an investor that is not required to prepare consolidated financial statements to account for associates using the equity method in its separate financial statements. The same options for accounting for associates are available in the separate financial statements of an investor as are available when it prepares consolidated financial statements. Therefore, the investment may be carried at cost, as an available-for-sale financial instrument or under the equity method#.

Forthcoming requirements

IAS 27.37, 28.13

The revised IAS 27 prohibits use of the equity method of accounting by an investor in its separate financial statements. Therefore, investments in associates that are not classified as held for sale in accordance with IFRS 5 should be accounted for either at cost or in accordance with IAS 39 in the separate financial statements of an investor. Revised IAS 28 also clarifies that an entity with no subsidiaries but with investments in joint ventures and / or associates is exempt from preparing financial statements using the equity method only if the exemption criteria in IAS 27 are met (see 2.5).

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3.5.10 Applying the equity method in separate financial statements

IAS 28.12 (2000), 27.29 (2000), 31.42 (2000)

An entity may account for a subsidiary, associate or joint venture under the equity method in its separate financial statements. A subsidiary that is exempt from consolidation (i.e., operates under long-term restrictions or acquired exclusively for resale in the near future) also may be accounted for under the equity method (see 2.5). In these cases the principles in 3.5.8 apply#.

Forthcoming requirements

IAS 27.37

The revised standard prohibits use of the equity method of accounting by an investor in its separate financial statements.

3.5.11 Accounting for jointly controlled entities

IAS 31.30, 38

When accounting for jointly controlled entities either use the equity method or proportionate consolidation.

The key difference between full consolidation and proportionate consolidation is that under proportionate consolidation only the investor's share of the assets and liabilities is accounted for and therefore there is no minority interest recognised.

IAS 31.33

In performing proportionate consolidation the usual consolidation procedures apply. For example, inter-entity eliminations are made to the extent of the investor's interest. See 2.5 for guidance on the application of consolidation principles. Only specific issues that arise in the application of these principles to joint ventures are addressed below.

When joint ventures are accounted for using the equity method, the guidance provided in 3.5.8 for accounting for associates would apply.

This area of IFRS may be subject to future developments (see 3.5.17).

Effective date

IAS 31 is applied from the date on which the investor obtains joint control. Given the requirement for joint control to be established contractually, it is unlikely that joint control will exist before the ratification by all the venturers of the agreement that establishes joint control.

Non-monetary contributions to joint ventures

SIC 13.5

When an entity contributes non-monetary assets in exchange for an equity interest in a jointly controlled entity, the entity recognises a gain or loss to the extent the assets have been sold to the other venturers. No gain or loss is recognised if:

- the significant risks and rewards of ownership of the contributed assets have not been transferred;
- the gain or loss cannot be measured reliably; or
- the non-monetary assets are similar to those contributed by the other venturers#.

Note, however, that the full amount of any loss should be recognised to the extent that the transaction reflects an impairment of the assets transferred.

Forthcoming requirements

SIC 13.5

Consequential amendments were made to the SIC interpretation on contributions to joint ventures as a result of the changes to IAS 16 regarding exchange of non-monetary assets. The previous exception for non-monetary assets contributed that are similar to those contributed by the other venturers has been replaced by an exception if the transaction lacks commercial substance as described in IAS 16 (see 3.2).

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Similar test#

SIC 13.5(c) Assets are similar when they are similar in nature, have a similar use in the same line of business and have similar fair values. These terms are not defined, and there is no detailed guidance as to their application.

In our view, "similar" should be assessed in the context of the individual component assets making up the operations of the respective venturers. For example, two venturers contribute operations of equal value to a joint venture. Both operations relate to dredging, but one business comprises a barge and a truck and the other business comprises a barge and a warehouse and the assets are similar only in respect of the barges. In our view, the "similar" test is not met since a contribution meets the similarity test only if *all* of the significant component assets are similar, on a one-to-one basis, to those contributed by the other venturers.

In a 50/50 joint venture we would interpret "similar" to mean that the respective fair values should be in a ratio very close to 50/50. Likewise, in a 55/45 joint venture, we would interpret "similar" to mean that the respective fair values should be in a ratio very close to 55/45.

In cases when one venturer contributes cash in addition to assets, this often is an indication that the contributed assets do not have a similar fair value.

Forthcoming requirements

SIC 13.5 Consequential amendments were made to the SIC interpretation on contributions to joint ventures as a result of the changes to IAS 16 regarding exchange of non-monetary assets. The previous exception for non-monetary assets contributed that are similar to those contributed by the other venturers has been replaced by an exception if the transaction lacks commercial substance as described in IAS 16 (see 3.2).

Elimination of unrealised gains

SIC 13.7 Unrealised gains or losses should be eliminated against the contributed asset if the proportionate consolidation method is applied or against the carrying amount of the investment if the equity method is applied. This means that a venturer will record its share of the non-monetary assets of a joint venture using the previously recorded book value of the underlying assets at the date of the transfer.

When the gain on the assets disposed of qualifies for recognition, the venturer will recognise its share of the assets it contributed at their carrying amounts at the date of the transfer and its share of the assets contributed by the other venturers at fair value.

The following example illustrates the application of SIC–13 when applying proportionate consolidation. In scenario 1 it is assumed that the assets are not similar# and a portion of the gain is recognised. In scenario 2 it is assumed that the assets are similar# and therefore the full gain is eliminated.

	A	*B*
Book value of non-monetary assets contributed	100	130
Fair value of non-monetary assets contributed	250	250
Share in joint venture	50	50

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The accounting entry in A to record the contribution is as follows:

	Debit	*Credit*
Investment in joint venture	250	
Assets contributed		100
Profit		150

The accounting entry in A to consolidate the joint venture is as follows:

	Debit	*Credit*
Joint venture assets	250	
Investment in joint venture		250

Scenario 1 – assets not similar#, eliminate only 50 per cent of profit

	Debit	*Credit*
Profit	75	
Joint venture assets		75

The elimination results in the following carrying amounts for the assets relating to the joint venture:

Retained share of contributed assets at book value	50
Share of acquired assets at fair value	125
	175

Scenario 2 – assets similar#, eliminate 100 per cent of profit

	Debit	*Credit*
Profit	150	
Joint venture assets		150

There is no guidance on how to eliminate the additional 75 profit. In our view, it should be eliminated against the assets acquired. This will result in the following carrying amounts for the assets relating to the joint venture:

Retained share of contributed assets at book value	50
Acquired assets at fair value less 75 unrealised profit	50
	100

Forthcoming requirements

SIC 13.5 Consequential amendments were made to the SIC interpretation on contributions to joint ventures as a result of the changes to IAS 16 regarding exchange of non-monetary assets. The previous exception for non-monetary assets contributed that are similar to those contributed by the other venturers has been replaced by an exception if the transaction lacks commercial substance as described in IAS 16 (see 3.2).

Allocation of unrealised profit

There is no specific guidance as to how an unrealised profit should be allocated to the individual assets of the joint venture. However, IFRSs indirectly establish the mechanics of proportionate consolidation (e.g., if the assets contributed are not similar, a gain or loss is recognised on the interest in the assets transferred to other venturers).

The retained interest is accounted for at its book value before the transfer (i.e., a carryover basis). Therefore, in our view, for the contributed assets to be measured on a carryover basis, an unrealised

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profit should be eliminated first against any goodwill or fair value adjustments on the transaction. For example:

	P	*Q*
Book value of contributed operations	180	160
Fair value of identifiable assets contributed	230	220
Fair value of operations contributed	250	250
Goodwill arising	20	30
Share in joint venture	50	50

If the assets are not similar#, P's accounting entry to record the contribution is as follows:

		Debit	*Credit*
Investment in joint venture	180/2 + 250/2	215	
Operations contributed			180
Profit			35

To proportionately consolidate the joint venture, P should record the following entry:

	Debit	*Credit*
Individual joint venture assets and liabilities (this includes P's share of goodwill on Q's contribution of 15)	215	
Investment in joint venture		215

The venturers' accounting is the same whether the joint venture records contributed assets at fair value or book value (see below), for example:

- own assets that are contributed are recorded on a carryover basis; and
- assets contributed by other venturers are recognised based on their fair value at the contribution date (if the assets are not similar).

Therefore, in the above example, P recognises goodwill of 15, which is the difference between the amount paid and the fair value of the identifiable assets contributed by Q ((250 - 220)/2).

If the joint venture recorded the contributed assets at fair value, then on consolidation P would reverse the fair value adjustments on the assets it contributed (half of which are consolidated proportionately on a carryover basis; the other half represent Q's interest and are not consolidated) and record its half of the assets contributed by Q at fair value. If the joint venture recorded the contributed assets on a carryover basis, P would make a consolidation adjustment to recognise its share of Q's contribution at its fair value of 125 (250/2) and account for its share of the assets it contributed on a carryover basis.

If the contributed assets are similar#, P should record all the contributed assets on a carryover basis. In this case P would not recognise any goodwill or any profit on the transaction.

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The consolidation entry would be:

	Debit	Credit
Investment in joint venture	180	
Assets contributed		180
Individual joint venture assets and liabilities	180	
Investment in joint venture		180

Forthcoming requirements

SIC 13.5 Consequential amendments were made to the SIC interpretation on contributions to joint ventures as a result of the changes to IAS 16 regarding exchange of non-monetary assets. The previous exception for non-monetary assets contributed that are similar to those contributed by the other venturers has been replaced by an exception if the transaction lacks commercial substance as described in IAS 16 (see 3.2).

Cash and non-monetary contributions

A contribution of cash to the joint venture that is not distributed to a venturer does not result in realisation of the gain or change the principles illustrated in the example. The cash simply would gross up the contribution to and assets of the joint venture. The profit elimination would not change.

Unrealised losses

If the transaction results in an unrealised loss, the loss is not eliminated if it provides evidence of an impairment of the contributed assets.

In the unusual situation when the unrealised loss does not provide evidence of impairment it is eliminated. It is important that the allocation of the loss to the individual contributed assets does not result in the carrying amount of any asset exceeding its recoverable amount (see 3.9). In our view, if the allocation results in an asset's carrying amount exceeding its recoverable amount, the excess should be allocated proportionately to the other non-monetary assets.

Accounting by joint ventures for contributions received

IAS 31 and SIC–13 address accounting for joint ventures from the point of view of the venturer. They are silent as to what treatment should be applied by the joint venture itself. When a joint venture prepares separate financial statements an issue arises as to whether it should account for the contributions received at their book values in the venturers' accounting records before the transfer (a carryover basis) or based on their fair values. If the joint venture does not prepare separate financial statements no issue arises.

The accounting treatment applied by the venturers is independent of the treatment applied by the joint venture itself (i.e., the venturers will reverse the accounting applied by the joint venture when they account for their interest in the joint venture), so this issue is relevant only to the separate financial statements of the venturer.

In the absence of specific guidance on accounting by joint ventures, some joint ventures use fair values, and others use a carryover basis, to record the contributions received from venturers.

In our view, it is appropriate to consider the principles in SIC–13 when determining the treatment to be applied by the joint venture. Generally, when the contributed assets are not similar# our preference is for the joint venture to recognise the contributions at fair value. We also believe that it is appropriate for the joint venture to apply the principles in accounting for business combinations (see 2.6) by analogy in measuring the fair values of the contributed assets.

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Whichever method is used, it should be applied consistently by the joint venture to all contributions from venturers.

Forthcoming requirements

SIC 13.5 Consequential amendments were made to the SIC interpretation on contributions to joint ventures as a result of the changes to IAS 16 regarding exchange of non-monetary assets. The previous exception for non-monetary assets contributed that are similar to those contributed by the other venturers has been replaced by an exception if the transaction lacks commercial substance as described in IAS 16 (see 3.2).

IFRS 3.36 The application, by analogy, of the business combination principles of IFRS 3 would include also the recognition and fair value measurement of contributed contingent liabilities.

Transactions with joint ventures

Unrealised profits on transactions with joint ventures are eliminated to the extent of the investor's interest in the joint venture. If an asset is sold at a loss and the loss provides evidence of impairment, the full amount of the loss is recognised.

Otherwise, when a venturer sells an asset to a joint venture, the venturer recognises only the share of any gain or loss attributable to the interests of the other venturers. When a joint venture sells assets to a venturer, the venturer eliminates its share of any gain or loss until the asset is sold to a third party.

Losses

Under proportionate consolidation there is no ceiling on the amount of losses to recognise. This differs from the approach to accounting for losses under the equity method, whereby the net investment normally is not reduced below zero (see 3.5.8).

Consistency and change in accounting method

The chosen accounting policy (proportionate consolidation or the equity method) must be applied consistently to all jointly controlled entities from period to period.

IAS 8.13 For example, W has investments in jointly controlled entities in Zambia, which it has proportionately consolidated. During the reporting period, W invests in a jointly controlled entity in Pakistan. W believes that the nature of the Pakistani joint venture is different in substance to those in Zambia and wishes to use the equity method for the joint venture in Pakistan. IFRSs would not permit this approach. If a policy of proportionate consolidation is adopted, it must be applied consistently to all jointly controlled entities, regardless of the nature of the jointly controlled entities.

As with other voluntary changes in accounting policy, a change in accounting policy with respect to joint ventures is justified only if the change results in more relevant and reliable information (see 2.8).

3.5.12 Accounting for jointly controlled assets

IAS 31.21 The investor includes in its financial statements its share of the jointly controlled assets, the liabilities and expenses that it incurs and any income from the sale or use of its share of the output of the joint venture. In addition, it should recognise any owned assets or liabilities it controls alone.

For example, S and T enter into a 50:50 joint venture arrangement to jointly develop and market a new software product. The total software development costs that qualify for capitalisation as an intangible asset under IFRSs are 200,000; costs of 80,000 do not meet the criteria for capitalisation (see 3.3). S and T each should recognise software development costs of 100,000 as an asset in the balance sheet and costs of 40,000 in the income statement. In future periods S and T should amortise the software over its estimated useful life and account for their share of any revenues or costs associated with marketing the software.

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3.5.13 Accounting for jointly controlled operations

IAS 31.15 For jointly controlled operations the investor includes, in its individual financial statements (and therefore also in its consolidated financial statements), the assets that it controls and the liabilities and expenses that it incurs in the course of pursuing the joint operation, plus its share of the income from the joint operation.

3.5.14 Impairment

IAS 28.33 Fair value adjustments and goodwill recognised on acquisitions of associates and joint ventures are not recognised separately. Accordingly, an investment in an associate or joint venture may be impaired, even if the investee has accounted for any impairment of the underlying assets. Therefore, investments in associates and joint ventures are subject to the impairment testing requirements in IAS 36. Accordingly, any resulting impairment losses first would be allocated to goodwill. See 3.9 for further guidance on recognising, measuring and presenting impairment losses.

3.5.15 Changes in the status of joint ventures and associates

Investment becomes an associate or joint venture

An investment may become an associate or joint venture when:

- the investor acquires an additional holding; or
- there is a change in circumstances that results in significant influence or joint control being obtained.

Cost of the acquisition

Often the investment previously will have been accounted for as an available-for-sale investment under IAS 39; it also may have been classified as held for trading (see 3.6). In our view, any fair value adjustments recorded previously should be reversed through equity. We believe that the starting point for equity accounting or proportionate consolidation should be the original cost of the investment, plus the cost of any additional investment.

As explained in 3.5.8, goodwill should be calculated based on the cost of the investment and the fair value of the net assets at the date of each acquisition.

Accounting for post-acquisition earnings

In some circumstances an investment in an associate or joint venture is accounted for as a financial asset if certain conditions have been met, as described in 3.5.5. If at a later date these conditions no longer are met, the investor would be required to commence accounting for the investment using the equity method or proportionate consolidation. In these circumstances, we believe that the investor's share of the results of the entity since acquisition (adjusted for amortisation of goodwill# and fair value adjustments) should be included in the current year's income statement, or directly in equity for items recorded directly in equity (e.g., the investor's share of unrealised gains on the associate's available-for-sale investments). Further, it would not be appropriate to restate comparatives or retained earnings.

Once the above adjustments have been made, equity should be the same as if the entity had been proportionately consolidated or accounted for using the equity method since joint control or significant influence arose. See 2.5 for an example of the application of these principles.

Application of the equity method or proportionate consolidation is not a change in accounting policy. Therefore, if the application of the equity method or proportionate consolidation is instead a correction of an error, the effect of which is material to the entity's financial statements, both comparative information and opening retained earnings will be restated (see 2.8).

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Forthcoming requirements

IFRS 3.54 Under IFRS 3 goodwill is not amortised (see 3.3).

Disclosure

The financial statements should include appropriate disclosure, including the share of the entity's results for the current year, the share of results for the comparative year and the aggregate share of results for prior years.

Increase in interest in an associate or joint venture

Where an investor's interest in an existing associate or joint venture is increased, the additional interest is accounted for in the same way as a step acquisition in a business combination (see 2.6).

Cessation of significant influence or joint control

IAS 28.18 The equity method or proportionate consolidation continues to apply until joint control or significant influence ceases. This may occur when the investment or a portion of the investment is sold, there is a dilution in shareholding, or there is a change in facts and circumstances.

Once an investment has been classified as an associate or joint venture, the investor will be regarded as continuing to have significant influence or joint control until a specific, identifiable event or transaction occurs that changes the circumstances. Insignificant or temporary changes in the relationship between the investor and the investee normally would not result in cessation of joint control or significant influence.

Sometimes judgement is necessary to determine when to account for a disposal. For example, X signs an agreement to sell associate Y to Z at a later date (e.g., in December 2005). Z wishes to obtain control of Y and Y's other shareholders also enter into similar agreements with Z. Final approval of the agreement is subject to approval of the transaction by the competition authorities and Z obtaining at least 70 per cent of Y. From the date the agreement is entered into X's voting rights are suspended.

It is necessary to evaluate whether X continues to have the ability to exercise significant influence over Y. In our view, the probability of the conditions being fulfilled and the sale occurring should be considered in making this evaluation. If there is a high probability that the sale will take place, and X is not able to exert significant influence, it may be appropriate to suspend equity accounting from the date the agreement is signed. If there is a reasonable possibility that the sale will not be approved and, in the event the sale is not approved, X would retain significant influence, it would be appropriate to continue equity accounting until the transaction is finalised.

Accounting for the disposal

When an investment accounted for using the equity method is sold, the difference between the proceeds from the disposal and the carrying amount of the investment (including the carrying amount of any related goodwill) is recognised in the income statement as a gain or loss on disposal.

When a jointly controlled entity is disposed of the gain or loss on disposal is the difference between the proceeds from the disposal and the investor's share of the net assets of the joint venture, including any related goodwill.

Partial disposal

IAS 28.18 In the case of a partial disposal, depending on the level of influence still held by the investor, the remaining investment is accounted for:

- as an associate in accordance with IAS 28; or
- as a financial asset in accordance with IAS 39 (see 3.6).

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IAS 28.18 If a joint venture becomes an associate, the investor's remaining interest in the carrying amount of the net assets of the investee is the deemed cost of the investment in the associate for the purposes of applying the equity method. Similarly, if an associate or joint venture becomes a financial instrument investment under IAS 39, the deemed cost of the investment for the purpose of applying IAS 39 is the investor's retained interest in the carrying amount of the net assets of the investee at the date of change in status of the investment.

For example, assume V has a 50 per cent interest in joint venture W. V proportionately consolidates joint ventures. V sells a 40 per cent stake in W for proceeds of 80,000. The remaining goodwill recorded by V relating to W on that date is 8,000. The carrying amount of V's interest in the net assets is 60,000. After the disposal V no longer has joint control or significant influence over W. W is treated as an available-for-sale investment under IAS 39 in future periods.

The calculation of the deemed cost of the available-for-sale investment and the profit on disposal of W is calculated as follows:

	50%	*40%*	*10%*
Share of net assets	60,000	48,000	12,000
Goodwill	8,000	6,400	1,600
Carrying amount / deemed cost	68,000	54,400	13,600
Proceeds received		80,000	
Profit on disposal		25,600	

The following accounting entry is used to record the transaction:

	Debit	*Credit*
Cash	80,000	
Available-for-sale investment	13,600	
Goodwill (included in the investment in associate		8,000
Net assets		60,000
Profit		25,600

Unrealised profits on previous transactions

In our view, unrealised profits from previous downstream sales to associates or joint ventures should be carried forward in the cost of the investment to the extent that the investment is retained. For example, U previously was a 20 per cent associate of T. On 1 December 2004, T sold half of its investment in U and no longer has significant influence over U. Therefore, T discontinues the use of the equity method. The carrying amount of T's investment in U at the date of the sale is 895,000. In a previous period, T sold land to U at a profit of 100,000. T eliminated the unrealised portion of the profit of 20,000 against the equity accounted carrying amount of its investment in U. No adjustment should be made to reverse the unrealised profit elimination in determining the cost basis for U. Therefore, the cost basis of T's remaining 10 per cent interest is 447,500 (895,000/2).

Dividends received after a partial disposal

IAS 18.32 There is no specific guidance on how to deal with a situation when an investee that previously was an associate or joint venture declares dividends from earnings that accrued in a period when it was accounted for as an associate or joint venture. In our view, if dividends received clearly are a distribution of profits that previously have been recognised by the investor, the dividends should be treated as a reduction in the cost of the investment and not shown as income. This is because the investor would have recognised the earnings in previous periods applying the equity method or proportionate consolidation. Therefore, it would be double counting to recognise the dividends in earnings again in a subsequent period. If it is difficult to allocate the amount of dividends received

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between pre- and post-disposal earnings except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a return of capital. This is consistent with the requirement to account for dividends declared from pre-acquisition net income as a deduction from the cost of an investment (see 4.2).

Dilution

A dilution of an interest in a joint venture or associate may occur, for example, when the investee issues shares to other parties. The accounting for the dilution of an interest in an associate or joint venture generally is the same as the accounting for dilutions of interests in subsidiaries. See 2.5 for an illustrative example of accounting for dilutions.

3.5.16 Presentation and disclosure

Changes in equity of associates

In our view, the method of recognising changes in equity of an associate in the investor's financial statements should be consistent with how the underlying transaction would be recognised under IFRSs. For example:

- a gain or loss on a cash flow hedging instrument should be recognised in the hedging reserve (see 3.6);
- a change arising from the revaluation of property, plant and equipment or an available-for-sale investment should be recognised in a separate component in equity (see 3.2 and 3.6); and
- exchange differences arising from translation of an associate's net investment in a foreign entity should be recognised directly in equity (see 2.7).

In our view, when a statement of changes in equity is presented, it is preferable to present a separate line item for the investor's share of changes in equity of associates, with each change included in the appropriate column. See 3.10 for an illustrative example of this presentation. When a statement of recognised gains and losses is presented, we recommend using a separate line item for the investor's share of gains and losses from associates (see 2.2).

Income statement presentation

IAS 1.81 Earnings accounted for under the equity method must be presented as a separate line item on the face of the investor's income statement. There is no specific guidance on where in the income statement the line item should be presented. In our view, it should be presented as part of profit or loss from ordinary activities; and may be shown either as part of operating result or financial income (see 4.1).

There also is no guidance on how the investor's share of associates' tax or minority interest should be treated. In our view, the investor's share of equity accounted earnings, *after* tax and minority interest, should be presented as a *single* line item in operating result or financial income *before* tax. This presentation results in a reconciling item in the tax rate reconciliation (see 3.12). We do not recommend showing the investor's share of associates' pre-tax income and proportionately consolidating the investor's share of associates' tax and minority interest.

Gain or loss on disposal and impairment losses

In our view, gains or losses arising on disposal of an associate (or joint venture) or impairment of a loan to an associate (or joint venture) are not part of the investor's share of the profit or loss accounted for using the equity method. We believe that these items should be recognised in the same line item as other gains and losses on investments and not in the profit or loss from associates line item.

Goodwill

As noted in 3.5.8, in our view, goodwill (or negative goodwill) on associates (and the related accumulated amortisation) should be presented as part of (or a reduction of) the carrying amount of investments in associates and not with goodwill from consolidated (or proportionately

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consolidated) investments. Similarly, the amortisation of goodwill should be presented as an adjustment to the earnings accounted for under the equity method in the income statement rather than being shown with other goodwill amortisation#.

Forthcoming requirements

IAS 28.23, IFRS 3.55 The revised standard confirms that goodwill should be included in the carrying amount of the investment in the associate and not shown separately. Under IFRS 3 goodwill is not amortised and therefore amortisation is not included in the determination of the investor's share of the associate's profit or losses.

IAS 28.23 Under the revised standard, negative goodwill is excluded from the carrying amount of the investment and is included as income in the determination of the investor's share of the associate's income statement in the period in which the investment is acquired.

IAS 28.17 (2000) IFRSs require goodwill on associates to be *accounted* for in the same manner as goodwill arising on business combinations (see 2.6), but IFRSs are silent on *disclosures* relating to goodwill on associates. In our view, it is not necessary to provide the disclosures for goodwill arising in a business combination in respect of goodwill on associates. However, we recommend that the amount of goodwill included in the carrying amount of associates and the amount amortised be disclosed in the notes#.

In some cases the amortisation of goodwill# arising on the acquisition of associates may exceed the investor's share of earnings from associates. In these cases, if an entity wishes to highlight the impact of the goodwill amortisation on earnings from associates, we recommend presenting two line items for earnings from associates: one showing the investor's share of results of associates and the other showing the goodwill amortisation. For example:

Share of results of associates	7,280
Amortisation of goodwill relating to associates	(9,000)
Earnings from associates	(1,720)

Forthcoming requirements

IAS 28.23, IFRS 3.55 The revised standard requires that goodwill should be accounted in accordance with IFRS 3 *Business Combinations*. Under IFRS 3 goodwill is not amortised.

Accounting policy notes

A situation may arise when an associate has accounting policies for items that are not applicable to the investor. The investor's financial statements do not include line items in respect of associate's financial statement items. In our view, it would be misleading for the investor's accounting policy notes to include additional notes in respect of the accounting policies of associates. If disclosure of accounting policies of an associate is considered necessary for an understanding of income from associates, or the carrying amount of investments in associates in the balance sheet, in our view, this information should be included in the associates' accounting policy note#.

Forthcoming requirements

IAS 28.26 The revised standard requires the use of uniform accounting policies for like transactions and events in similar circumstances. If an associate uses accounting policies other than those of the investor for like transactions and events in similar circumstances, adjustments should be made to conform the associate's accounting policies to those of the investor when the associate's financial statements are used by the investor in applying the equity method.

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Proportionate consolidation

IAS 31.34 Proportionate consolidation may be done by:

- including the investor's share of each line item in the joint venture's financial statements with each relevant line item of the investor (in the same way as a normal consolidation); or
- presenting separate line items for the investor's share of each of the investee's assets, liabilities, revenues and expenses.

The following example illustrates the different approaches permitted for presentation of operating income. Other items in the financial statements would be dealt with in the same way.

Combined disclosures

Revenue	107,403
Cost of sales	(61,076)
Gross profit	46,327
Other operating income	1,571
Distribution costs	(18,090)
Administrative expenses	(15,635)
Other operating expenses	(3,284)
Profit from operations	10,889

If the combined presentation is used, information about the amounts relating to joint ventures should be disclosed in the notes. For example:

Included in the primary financial statements are the following amounts relating to joint ventures:

Revenue	12,657
Cost of sales	(7,341)
Gross profit	5,316
Other operating income	-
Distribution costs	(1,473)
Administrative expenses	(1,685)
Other operating expenses	(438)
Profit from operations	1,720

Separate line items

	Group (excluding joint ventures)	*Joint ventures*	*Total group*
Revenue	94,746	12,657	107,403
Cost of sales	(53,735)	(7,341)	(61,076)
Gross profit	41,011	5,316	46,327
Other operating income	1,571	-	1,571
Distribution costs	(16,617)	(1,473)	(18,090)
Administrative expenses	(13,950)	(1,685)	(15,635)
Other operating expenses	(2,846)	(438)	(3,284)
Profit from operations	9,169	1,720	10,889

This method significantly increases the information contained in the primary financial statements. In our view, this presentation is preferable only if, due to the nature or significance of joint ventures, this level of detail is considered helpful for an understanding of the financial statements.

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3.5.17 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Joint ventures

The IASB has begun a limited project covering the definition of joint ventures and the distinction between a joint venture and an undivided interest in an asset. The IASB has indicated that it intends to retain the requirement for contractually established joint control. The IASB also has expressed an intention to eliminate proportionate consolidation, but possibly to replace it with an adapted form of equity accounting.

The IASB also has begun a longer-term project on the accounting for joint venture arrangements.

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3.6 Financial instruments

(IAS 21, IAS 32, IAS 39)

Overview

- **All derivatives are recognised on the balance sheet and measured at fair value.**
- **All financial assets must be classified into "loans and receivables", "held-to-maturity", "fair value through profit or loss" or "available-for-sale" categories.**
- **Loans and receivables and held-to-maturity financial assets are measured at amortised cost. All other financial assets are measured at fair value (with limited exceptions).**
- **Changes in the fair value of available-for-sale assets are recognised directly in equity.**
- **Financial liabilities, other than those held for trading purposes or designated as at fair value through profit or loss, are measured at amortised cost.**
- **Any financial instrument may be designated on initial recognition as one measured at fair value through profit or loss.**
- **Evaluating whether a transfer of a financial asset qualifies for derecognition requires considering:**
  - **Whether substantive risks and rewards are transferred. If substantially all the risks and rewards are transferred, then a financial asset is derecognised. If substantially all the risks and rewards are retained, then the asset is not derecognised.**
  - **If some but not substantially all of the risks and rewards are transferred, then an asset is derecognised if control of the asset is transferred.**
  - **If control is not transferred, then the entity continues to recognise the transferred asset to the extent of its continuing involvement in the asset.**
- **Whenever there is objective evidence that a financial asset measured at amortised cost, or fair value with changes recognised in equity, may be impaired the amount of any impairment loss must be calculated and recognised in the income statement.**
- **Generally, derivatives embedded in host contracts must be accounted for as stand-alone derivatives. Exceptions are provided when the host contract is measured at fair value with changes in fair value recognised in the income statement and for embedded derivatives that are closely related, in economic terms, to the host contract.**
- **Hedge accounting is permitted only when strict documentation and effectiveness testing requirements are met.**
- **The type of hedge accounting applied depends on whether the hedged exposure is a fair value exposure, a cash flow exposure, or a currency exposure on a net investment in a foreign operation.**

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For ease of use, this section is based on the revised versions of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* published in March 2004. The impact on current versions of IAS 32 and IAS 39 as a result of amendments to IAS 32 and IAS 39 in December 2003 and March 2004 are discussed in a separate KPMG publication *Financial Instruments Accounting* (March 2004). A summary of the key changes is included in section 3.6.18. The transitional provisions of the amended standards are discussed in 3.6.17.

3.6.1 Scope

IAS 32.4-10 IAS 32 deals with the presentation and disclosure of financial instruments (see 5.6); generally it does not address recognition or measurement issues, but it does contain accounting principles for own equity instruments.

IAS 39.2-7 IAS 39 provides recognition and measurement requirements covering most financial instruments other than assets and liabilities arising from employee benefit plans, own equity instruments, certain guarantees, contingent consideration in business combinations and other exceptions discussed in more detail below.

The scope paragraphs of IAS 32 and IAS 39 are not identical and, consequently, a scope exclusion in IAS 39 in respect of a particular item should not be assumed to apply equally to that item in the context of IAS 32 and *vice versa*. For example, certain financial instruments might be excluded from the recognition and measurement requirements of IAS 39, due to another standard addressing those aspects of its accounting, while the disclosure requirements of IAS 32 still apply.

Insurance

IAS 39.2(e), 3 Although IAS 32 and IAS 39 do not address accounting for insurance contracts, they do not scope out insurance *entities*. Insurance entities must apply IAS 32 and IAS 39 to all their financial instruments other than those that meet the definition of an insurance contract or a contract with a discretionary participating feature. Therefore, financial instruments that meet the definition of an insurance contract and that are within the scope of IFRS 4 are not subject to IAS 39. However, IAS 39 applies to a derivative that is embedded in contracts that are within the scope of IFRS 4, if the derivative is not *itself* a contract within the scope of IFRS 4 (see 5.10).

Share-based payments

IFRS 2 provides guidance on accounting for share-based payments. Accordingly, the initial classification and measurement and subsequent measurement of financial instruments arising from share-based payment transactions as defined in IFRS 2 are subject to the requirements of that standard. Otherwise, financial instruments arising from these transactions would generally fall within the scope of IAS 32 and IAS 39.

Lease rights and obligations

IAS 39.2(b) Rights and obligations under leases are recognised and measured under IAS 17 (see 5.1) and consequently are not subject to the general recognition and measurement requirements of IAS 39. However, lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of IAS 39. Also, finance lease payables recognised by a lessee are subject to the derecognition principles of IAS 39.

IAS 39.2(b) Derivatives embedded in leases (both finance and operating leases) are within the scope of IAS 39 (see 3.6.15).

IAS 32.AG9 A finance lease is a financial instrument. IAS 32 applies to all financial instruments, and rights and obligations under leases are not specifically excluded from the scope of IAS 32. Consequently, recognised financial assets and liabilities arising from finance leases are subject to the financial instrument disclosure requirements contained in IAS 32 (see 5.6).

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Investments in subsidiaries, associates and joint ventures

IAS 32.4(a), 39.2(a)

Investments in subsidiaries, associates and joint ventures, that are consolidated, equity accounted or proportionately consolidated under IAS 27, IAS 28 and IAS 31 respectively (see 2.5 and 3.5) are excluded from the scope of IAS 32 and IAS 39.

IAS 32.4(a), 39.2(a)

IAS 39 also applies to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity (see 5.6). Similarly, IAS 32 and IAS 39 apply to derivatives held by the reporting entity on interests in subsidiaries, associates and joint ventures that are owned by other parties.

A parent may invest in a convertible instrument issued by a subsidiary. In our view, if the convertible instrument is classified as equity by the subsidiary (e.g., because it is mandatorily convertible, see 5.6), then in the separate financial statements of the parent its investment should be considered to be an investment in a subsidiary and therefore would be excluded from the scope of IAS 39. However, we believe that, if the subsidiary classifies the instrument as debt, the parent's investment in the subsidiary's liability would be subject to IAS 39. The conversion feature would be an embedded derivative (see 3.6.15).

Venture capital and similar entities

IAS 28.1, 31.1, 39.AG3

Venture capitalists, mutual funds, unit trusts and similar entities may account for their associates and investments in joint ventures at fair value under IAS 39, with all changes in fair value recognised in the income statement, rather than applying equity accounting or proportionate consolidation. However, there is no exemption for these entities from the requirement to consolidate all entities that they control.

In our view, an entity that has substantive venture capital operations may use the exemption from equity accounting and proportionate consolidation, even if the entity also has other operations. However, this exemption may be applied only to the investments held as part of the venture capital portion of the entity's operations.

IAS 27.13

Control is assumed in all cases when an investor holds more than 50 per cent of the voting shares in an entity, unless it can be demonstrated clearly that the investor does not have the ability to exercise control (see 2.5).

Investment funds and similar entities therefore should identify investments in which they have a holding of more than 50 per cent of the voting shares, or are able to exercise control by some other means. These investments must be consolidated unless they qualify for the limited exemptions from consolidation (see 2.5).

3.6.2 Definitions

IAS 32.11

A financial asset is defined as any asset that is:

- cash;
- a contractual right:
  - to receive cash or another financial asset; or
  - to exchange financial assets or financial liabilities under potentially favourable conditions;
- an equity instrument of another entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of shares.

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IAS 39.IGB1 Gold bullion is a commodity and not a financial asset; therefore it is not within the scope of IAS 39 or IAS 32.

IAS 32.11 A financial liability is defined as:

- a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial instruments under potentially unfavourable conditions; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

IAS 32.AG11 Deferred revenue in advance and prepaid expenses generally are not financial instruments.

3.6.3 Derivatives

Definition

IAS 39.9 A derivative is a financial instrument, the value of which changes in response to some underlying variable (e.g., an interest rate), that has an initial net investment smaller than would be required for other instruments that have a similar response to the variable, and that will be settled at a future date.

IAS 39.IGB3 A contract that allows either net or gross settlement may be a derivative.

In our view, an individual contract should be treated as a single derivative and not split into its component parts. For example, an interest rate collar cannot be separated into an interest rate cap and an interest rate floor, which are accounted for separately.

Underlying

IAS 39.IGB2 The term "underlying" does not refer to an asset or liability in the balance sheet, but rather a variable that creates changes in the value of a contract. Examples of underlying variables include interest rates, creditworthiness and foreign exchange rates.

An option that is exercisable at the fair value of the underlying always has a fair value of zero. Therefore, it does not meet the definition of a derivative because its value does not depend on an underlying variable.

Notional amount

IAS 39.IGB8 Although derivatives normally have a notional amount specified in the contract, the definition of a derivative does not require there to be a notional amount. A contract to pay or receive a fixed amount on the occurrence or non-occurrence of a future event meets the definition of a derivative.

"Smaller" initial net investment

IAS 39.IGB9 There is no quantified guidance about what constitutes a "smaller" initial net investment. "Smaller" should be interpreted relative to the investment that would be required to acquire a direct investment in a primary (i.e., non-derivative) instrument with similar characteristics to the derivative. An instrument with similar characteristics to the derivative is one that has a similar response to changes in the underlying variable. For example, to evaluate whether the premium paid for an option to acquire an equity security is smaller than the amount that would need to be paid to acquire a similar primary financial instrument, the amount paid should be compared to the amount that would need to be paid to acquire a direct investment in the underlying equity security.

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For this reason, debt and equity securities are not derivatives, although their fair values have similar responses to changes in the underlying (interest rates or the share price) as derivatives on these instruments.

Many derivatives, such as at-market forward contracts, do not have any initial cost.

IAS 39.IGB9 Options normally require payment of an up-front premium, but the amount paid normally is small in relation to the amount that would be required to be paid to acquire the underlying instrument. However, certain call options may have a very low exercise price so that the amount paid to acquire the option is likely to be equivalent to the amount that would be paid to acquire the underlying asset outright at inception of the option. In our view, such options should be treated as a purchase of the underlying asset and not as derivatives. In other words, if an option is so deep in the money at the date it is issued or acquired that the cost of the option is almost equal to the value of the underlying asset at that date, it should be accounted for as an investment in the underlying asset and not as a derivative.

A cross-currency swap meets the definition of a derivative even though there is a swap of currencies at inception of the contract because there is zero initial *net* investment.

IAS 39.IGB10 Any required deposits or minimum balance requirement held in margin accounts as security for derivatives are not considered part of the initial investment. For example, the variation margin required in respect of exchange traded futures comprises cash collateral for the particular trade rather than either part of the initial investment in the underlying commodity or an amount paid in settlement of the instrument.

Settled at a future date

IAS 39.IGB7 Although an option may not be exercised, it still meets the "settled at a future date" requirement because, expiry at maturity is a form of settlement.

Impact of partial prepayments

IAS 39.IGB4, 5 If part of a derivative is prepaid, the unpaid remainder is a derivative if all of the definition criteria are met. For example, if the variable rate leg payable of an interest rate swap is prepaid based on market rates at inception, the prepaid amount provides a return (from the fixed rate leg receivable) that is the same as that of an amortising fixed rate debt instrument with a principal amount equal to the prepayment. Therefore, the instrument fails the "smaller net investment test" and is not treated as a derivative, but rather as a loan or similar non-derivative financial instrument with a fixed return. However, if the fixed leg is prepaid the prepayment amount is significantly less than the notional amount on which the variable payments under the variable leg will be calculated and is thus smaller than the cost of acquiring a non-derivative financial instrument that would have a similar response to changes in market factors (e.g., a variable rate bond, as described above). Also, the instrument's fair value changes in response to changes in interest rates and it is settled at a future date. Therefore, such an instrument meets the definition of a derivative.

Right to acquire a subsidiary, associate or joint venture

IAS 27.IG7 To assess whether an entity controls, or has significant influence over, an investee, the investor considers not only its current ownership, but also any current rights to acquire such interests (see 2.5 and 3.5). In our view, any derivative considered to be the basis for a conclusion that control, joint control, or significant influence exist are not considered part of the investment in a subsidiary associate or joint venture. Therefore, the scope exclusion in IAS 39 for investments in subsidiaries, associates and joint ventures normally would not apply. However, if the derivative provides a present ownership interest (e.g., not only the ability to control but also currently provides the benefits of such control) then, in our view the derivative does comprise part of the entity's investment and is covered by the scope exclusion in IAS 39.

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Exemptions from derivative treatment

Purchases and sales of non-financial items

IAS 39.5 A commitment to buy or sell a non-financial item (e.g., a commodity contract that can be settled in cash) is treated as a derivative, even if it is not a financial instrument, *unless* the contract was entered into for the entity's purchase, sale or usage requirements.

IAS 39.6 In general, a commitment to buy or sell a non-financial item is treated as a derivative if:

- the terms of the contract permit either party to settle in cash or another financial instrument (e.g., a written option that permits cash settlement);
- the entity has a past practice of settling similar contracts net in cash or other financial instruments;
- the entity has a past practice of taking delivery of the underlying and selling it within a short period after delivery for trading purposes; or
- the non-financial item that is subject to the contract is readily convertible into cash.

IAS 39.AG54 A purchase or sale contract that is required to be treated as a derivative is measured at fair value through profit or loss in the period between trade and settlement date.

IAS 39.AG35(b) Other contracts to purchase or sell non-financial items are not treated as derivatives. The underlying purchase or sale transaction is accounted for in accordance with the relevant standard.

For example, an airline operator purchases an aircraft directly from the manufacturer. In order to protect prices of aircraft in the secondary market, the manufacturer writes an option under which it may be required to repurchase the aircraft from the airline operator at a specified price after a specified period, which is consistent with the useful life of the aircraft for the particular airline operator. The repurchase option granted to the airline operator is not treated as a derivative by either of the parties, unless the manufacturer intends to take delivery of the aircraft and sell it immediately, or has a past practice of settling similar contracts in cash. Therefore, the repurchase option comprises an executory contract, which would not be recognised in the financial statements of the airline operator or the manufacturer unless it was considered onerous, in which case IAS 37 would apply (see 3.11). If the option is exercised, the airline operator will treat the exercise of the option as a sale of an asset. The proceeds from the sale of the asset is the amount received (i.e., the option exercise price). The manufacturer will treat the transaction as a purchase of the asset.

Regular way contracts

IAS 39.9, 38, 39.AG 53-56 Regular way contracts are contracts to buy or sell financial assets that will be settled within the time frame established by regulation or convention in the market concerned (not necessarily an organised market). Regular way contracts are not treated as derivatives between trade date and settlement date (see 3.6.5 and 3.6.13).

For example, a commitment for three-day settlement of a security is not treated as a derivative if three days is the normal settlement period for this type of transaction in the environment in which the transaction takes place. However, in a market with three-day settlement, if a contract specifies that settlement will take place only in three months, the exception does not apply and the contract is treated as a derivative between trade date and settlement date.

IFRSs do not offer any specific guidance on how to treat a delay in settlement of a regular way contract. In our view, a delay would not preclude the use of the regular way exemption if the contract requires delivery within the time frame established by the convention in the market, and the delay is caused by a factor that is outside the control of the entity.

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Loan commitments

IAS 39.2(h), 4 A loan commitment that can be settled only by the loan being advanced and cannot be settled net in cash or other financial assets is not treated as a derivative, and it is excluded from the scope of IAS 39. However, if the entity has a past practice of selling the resulting loans shortly after origination, then *all* loan commitments in that class must be treated as derivatives. If an entity chooses to designate its loan commitments as at fair value through profit or loss, such loan commitments are within the scope of IAS 39.

IAS 39.2(h) An issuer of a commitment that is not a derivative to provide a loan at below-market rates initially should recognise the loan commitment at its fair value and subsequently measure the loan commitment at the higher of (i) the amount recognised under IAS 37, and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.

Derivatives on own equity

IAS 39.2(d) In some cases derivatives on own equity are required to be treated as derivatives. See 5.6 for further details.

Financial guarantee contracts

IAS 39.2(e), 3 Financial guarantee contracts, including letters of credit, that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument, meet the definition of insurance contracts under IFRS 4 provided that their terms result in the transfer of significant insurance risk to the issuer. These contracts are excluded from the scope of IAS 39 and thus are accounted for under IFRS 4. However, if a financial guarantee contract that meets the definition of an insurance contract is entered into or retained on transferring to another party financial assets or financial liabilities that are within the scope of IAS 39, such financial guarantee contract should be accounted for by the issuer under IAS 39. This area of IFRSs may be subject to future developments (see 3.6.19).

IAS 39.3 Other financial guarantee contracts that require payments to be made in response to changes in another specified variable, for example, interest rate, credit rating or credit index, are within the scope of IAS 39 provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract.

Other

IAS 39.2, 39.AG49 An example of contracts that would not be treated as derivatives under IAS 39 include rights and obligations arising on the transfer of a financial asset that does not qualify for derecognition, if recognising the derivative would result in recognising the same rights or obligations twice.

3.6.4 Classification

IAS 39.9 All financial instruments (i.e., not just securities) are classified as one of the following categories on initial recognition:

- financial assets or financial liabilities measured at fair value through profit or loss (the "fair value through profit or loss" category);
- held-to-maturity assets;
- loans or receivables (assets);
- available-for-sale assets; or
- other liabilities.

In our view, if an entity acquires financial instruments as part of a business combination, the entity should classify the acquired financial instruments at the acquisition date applying the normal classification rules, without regard to how the instruments were classified by the acquiree before the acquisition.

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The classification rules for each of the categories are set out below.

Financial assets or financial liabilities at fair value through profit or loss, including derivatives

IAS 39.9

This category includes:

- financial assets or liabilities held for trading (i.e., any financial asset or liability held to generate short-term profits or that is part of a portfolio of financial instruments that are managed together for that purpose);
- all derivatives other than hedging instruments (see 3.6.3 for the definition of a derivative); and
- any financial assets or liabilities that are designated by the entity at the time of initial recognition as measured at fair value through profit or loss.

IAS 39.9, 39.1GB11

The above definition of held for trading refers to an asset or liability being part of a portfolio of financial instruments. While IAS 39 does not explicitly define 'portfolio', used in this context it suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of the same group. Consequently, in our view, it is possible for a portfolio to consist of both assets and liabilities held with a trading intent. For example, the takings and placings of a money market desk may be viewed as comprising one portfolio, which qualifies for classification as held for trading.

IAS 39.9

Designation of instruments as fair value through profit or loss is permitted for any instrument, except equity instruments that do not have a quoted market price in an active market and whose fair value cannot be measured reliably. It is important to note that this designation is available only upon initial recognition of the instrument and is irrevocable. See 3.6.9 for additional guidance on this designation.

Examples of instruments that commonly are classified in this category include:

- derivatives;
- certain marketable debt and equity securities; and
- liabilities arising from short sales.

IAS 39.9, 39.IGB11

When evidence indicates that a financial asset is being held for trading purposes, the instrument must be classified as an instrument measured at fair value through profit or loss. There is no detailed guidance on how to determine whether an entity has a trading intention. The turnover and the average holding period of financial assets in a portfolio may indicate a trading intention. For example, a pattern of frequent buying and selling of investments establishes a pattern of trading and additional investments that are purchased for this portfolio should be classified as trading instruments.

IAS 39.9, 39.IGB12

In our view, if an entity makes an investment in a fund that is managed independently by a third party, the classification of the entity's investment in that fund would not be influenced by the fact that the underlying assets within the fund are traded actively. Therefore, the entity's investment in that fund would not meet the definition of an asset held for trading unless the entity actively trades in the investments it holds in such funds. This situation may be contrasted with one in which an entity holds a portfolio of investments, which are managed by a portfolio manager on the entity's behalf. In such case the entity determines the investment policies and procedures and consequently, if the portfolio manager actively buys and sells instruments within the portfolio to generate short-term profits, the instruments in the portfolio are considered held for trading and are classified as fair value through profit or loss.

In our view, a liability should not be considered as held for trading simply because it funds trading activities. However, liabilities that fund trading activities could be designated as instruments at fair value through profit or loss. This area of IFRSs may be subject to future developments (see 3.6.19).

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Held-to-maturity assets

Definition

IAS 39.9 A held-to-maturity asset is one that has a fixed maturity and fixed or determinable payments and that the entity has the positive intent and ability to hold until maturity.

IAS 39.AG25 The intent and ability to hold an asset to maturity must be assessed at each balance sheet date.

IAS 39.9, 39.AG17-19 Types of instruments that may meet the held-to-maturity definition include:

- a fixed maturity debt security that bears interest at a fixed or variable rate;
- a fixed maturity debt security even if there is a high risk of non-payment, provided that the security's contractual payments are fixed or determinable and the other criteria for classification are met;
- a perpetual debt instrument that will pay interest for a specified period only, since the interest payments are fixed or determinable and will cease at a specified future date;
- a debt instrument that is callable by the issuer, as long as substantially all of the carrying amount would be recovered if the call were exercised; and
- shares with a fixed maturity (or callable by the issuer) that are classified as liabilities by the issuer (see 5.6).

IAS 39.9, 39.AG17-19 The following instruments cannot qualify to be classified as held-to-maturity:

- equity securities;
- an investment that the investor intends to hold for an undefined period or that does not have fixed or determinable payments;
- an investment that the investor stands ready to sell in response to changes in market conditions;
- a perpetual debt instrument that will pay interest in perpetuity;
- an instrument that is redeemable at the option of the issuer at an amount significantly below amortised cost;
- an instrument that is puttable by the holder, because paying for the put feature is inconsistent with an intention to hold the instrument to maturity – i.e., it is questionable whether the holder has the intent to hold the instrument to its maturity if the holder simultaneously acquires the right to require the issuer to redeem the instrument before its maturity date;
- an asset that the entity does not have adequate resources to hold to maturity; and
- an asset that is subject to legal constraints which mean that the entity may be unable to hold it to maturity.

In our view, an instrument that is compulsorily convertible, or convertible at the option of the holder at the maturity date, may be classified as held-to-maturity. This is because we view the conversion feature in the same way as a put or call option. However, we do not believe that an instrument that is convertible at the option of the holder, but not on a specified date, may be classified as held-to-maturity. Paying for an early conversion right is inconsistent with an intention to hold the instrument to its maturity.

Also, in our view, instruments that have an equity nature because payments are dependent on residual cash flows (e.g., subordinated notes for which the amount of interest or principal paid to the holder will be determined based on the residual remaining after interest and principal amounts in respect of other creditors are paid) should not be classified as held-to-maturity instruments.

Similarly, in our view, investments in funds for which the amount to be paid out as distributions or on liquidation is not fixed or determinable because it is based upon performance of the fund generally may not be classified as held-to-maturity, even if the fund has a final liquidation date (e.g., 10 years after the fund closes to additional investments).

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Tainting rules

IAS 39.9, 39.IGB19

An entity is prohibited from classifying any financial assets as held-to-maturity if the entity has sold, reclassified, transferred or exercised a put option on more than an insignificant amount of held-to-maturity assets in the current or previous two years, other than:

- when the asset was sufficiently close to maturity or the asset's call date that changes in market interest rates no longer had a significant effect on the asset's fair value;
- sales after collecting substantially all of the principal; or
- sales due to an isolated non-recurring event that is beyond the entity's control and which it could not reasonably have anticipated.

Sales for other reasons "taint" the entity's ability to classify any instruments as held-to-maturity.

IAS 39.9, 52, 39.IGB19

If a sale or reclassification of a held-to-maturity asset results in tainting, all existing held-to-maturity assets must be reclassified as available for sale for the current and next two full financial reporting years.

IAS 39.IGB20, 21

The tainting rules apply to all held-to-maturity investments across an entire group, not only those in a particular category or portfolio, or in a certain legal entity.

In our view, individual transfers within the current financial year or two preceding years should be aggregated in assessing the significance of transfers.

IAS 39.AG22, 39.IGB15, 17

Examples of sales that would not result in tainting include sales due to: a significant deterioration in the issuer's creditworthiness; a change in tax law that reduces the tax-exempt status of the asset; a need to adjust risk exposure following a major business combination; a change in laws that restricts or increases restrictions on permissible investments; a significant increase in capital requirements; or a significant increase in risk weights of a held-to-maturity asset for regulatory capital calculations. However, in our view, an increase in the tax rate does not equate to a change in tax law that reduces the tax-exempt status of an asset.

In our view, if an entity holds a put option that it *intends* to use only in the event of a change in laws, a voluntary exercise of that option by the entity nevertheless would result in tainting. However, if the exercise of an option is conditional upon a change in laws, or the option only comes into existence as a result of a change in laws, a sale in terms of such option would not give rise to tainting.

IAS 39.IGB16

There is no exception from the tainting rules for sales that are a result of a change in management, or for sales and simultaneous reinvestment in similar assets.

In our view, if investments acquired in a business combination were classified as held-to-maturity by the acquiree, but the acquirer does not have the intent or ability to hold these securities until maturity, the instruments should be reclassified and the tainting rules would not apply in the consolidated financial statements. However, transferring instruments held by the acquirer before the acquisition from the held-to-maturity portfolio would result in tainting.

In our view, a sale following a group reorganisation (including a common control transaction) that is not a major business combination would result in tainting. However, we do not believe that a sale of a held-to-maturity instrument between group entities would result in tainting in the consolidated financial statements, as long as the instrument remains classified as held-to-maturity in the consolidated financial statements. However, in the separate financial statements of the individual entities within the group, such intra-group transactions may give rise to tainting.

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IAS 39.IGB18 Entering into a repurchase or securities lending agreement is not considered a sale or transfer since it does not result in derecognition of the loaned asset. Therefore, an entity may continue to classify as held-to-maturity a debt instrument that has been loaned and returned under a lending agreement.

Issues to consider before using the held-to-maturity classification

There is no requirement to use the held-to-maturity classification. An instrument with fixed and determinable payments may be classified as available for sale even if the entity might hold the instrument until its maturity. In our view, this applies even if there are legal restrictions that require an instrument to be held until its maturity.

IAS 39.79 Hedge accounting is not allowed for hedges of interest rate risk on held-to-maturity instruments (see 3.6.16).

Loans or receivables

IAS 39.9 This category is for non-derivative financial assets with fixed or determinable payments, which arise from the lending of money, or supply of goods or services. It also includes purchased loans and receivables that are not quoted in an active market. The category excludes:

- loans and receivables that are quoted in an active market;
- loans and receivables that are actively and frequently purchased or originated and sold with the intention of generating a profit from short-term fluctuations in price or dealer's margin (these loans would be classified as fair value through profit or loss);
- loans and receivables for which the entity may not recover substantially all its initial investment for reasons other than credit deterioration (e.g., asset-backed securities); these loans would be classified as available for sale; and
- loans and receivables designated as fair value through profit or loss or available-for-sale.

Examples of loans and receivables include:

- trade and long-term receivables;
- unlisted debt instruments;
- loans and advances extended by a bank to its customers;
- purchased loans, including those acquired in a securitisation;
- syndicated loans; and
- a bank's term deposits with a central bank or other banks.

Classification of financial instruments as loans or receivables is based on the nature of the items and does not require an intention or ability to hold the instruments to maturity.

Available-for-sale assets

IAS 39.9 Any financial asset that does not fall into any of the previous three categories is classified as available for sale. A financial asset that the entity intends to hold to maturity or a loan or receivable also may be designated as available for sale on initial recognition.

This category normally includes all debt and equity securities that are not classified as fair value through profit or loss or as held-to-maturity.

Other liabilities

All liabilities not in the "fair value through profit or loss" category are other liabilities.

This category includes trade payables, borrowings, bonds issued and, for a bank, deposits from customers, unless they are designated as at fair value through profit or loss.

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3.6.5 Initial recognition

IAS 39.14

Generally, financial instruments are recognised when an entity becomes subject to the contractual provisions of the instrument.

Trade and settlement date accounting

IAS 39.38, 39.AG53-56

A primary (i.e., non-derivative) financial instrument that will be delivered within the time frame generally established by regulation or convention in the market concerned (a "regular way" transaction, see 3.6.3) may be recognised on the date the transaction is committed (trade date) or on the date when the instrument actually is transferred (settlement date).

IAS 39.AG53

The method adopted must be applied consistently to all purchases *and* all sales of financial assets in the same category.

The difference between trade-date and settlement-date accounting is in the timing of recognition of the instrument. This could have a significant impact on the balance sheet, particularly in respect of instruments whose fair values change significantly within a short space of time.

IAS 39.AG55, 56, 39.IGD2.2

Changes in the value of an asset between trade date and settlement date are attributable to the purchaser. Therefore, if the item purchased is measured at fair value, the purchaser recognises changes in value of the instrument between the trade date and the settlement date, regardless of which method is applied. Under settlement date accounting, while the underlying asset is not recognised until the settlement date, changes in value on the underlying asset are recognised. Therefore, the fair value adjustment is shown as a receivable or payable until the settlement date, at which date the receivable or payable adjusts the amount initially recognised for the asset. This results in the asset being measured at its fair value on the settlement date. The fair value changes between the trade date and the settlement date will be recognised in profit or loss for assets classified as at fair value through profit or loss, or directly in equity for assets classified as available for sale.

IAS 39.AG56

When the item purchased is measured at cost or amortised cost, any change in the fair value of the asset between the trade date and the settlement date is not recognised.

In our view, a change from settlement date to trade date accounting (or *vice versa*) is a voluntary change in accounting policy that should be accounted for under IAS 8 (see 2.8).

Derivatives

Derivatives are recognised from the date the contract is entered into, rather than on the settlement date.

Normal purchases and sales

IAS 39.AG35(b)

Normal purchases and sales that are not considered derivatives (see 3.6.3) are outside the scope of IAS 39. Therefore, IAS 39 does not impact the timing of recognition of these contracts. For example, a binding purchase order is not recognised until the risks and rewards of ownership of the underlying goods are transferred (see 3.7).

3.6.6 Initial measurement

IAS 39.43

All financial instruments initially are measured at fair value.

IAS 39.44

A financial asset that will be measured at cost subsequent to initial recognition (see 3.6.7) initially is measured at its fair value.

IAS 39.AG64, 65, 76

Generally, it is not appropriate to recognise any gain or loss on the initial recognition of a financial instrument since the best evidence of the fair value of an instrument at initial recognition is presumed to be the transaction price (i.e., the cost). This presumption may be overcome only if evidenced by comparison with other observable current market transactions in the same instrument or based on a

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valuation technique whose variables include only data from observable markets. There are certain exceptions to this presumption (see *Low-interest and interest-free loans* below and 3.6.9).

Transaction costs

IAS 39.43, 39.AG13

Transaction costs are included in the initial measurement of financial instruments that are not measured at fair value through profit or loss. Transaction costs are those incremental costs directly attributable to acquiring or issuing a financial instrument, and exclude internal administrative or holding costs. See 4.6 for additional guidance.

Low-interest and interest-free loans

IAS 39.AG64, 65

In most cases the fair value of a financial instrument on initial recognition will be equal to its cost. However, sometimes interest-free or low-interest loans are given (e.g., by a shareholder or government), to attract customers, or as a means of passing on tax benefits.

In our view, in assessing whether the interest charged on a loan is below-market rates, consideration should be given to the terms and conditions of the loan, local industry practice and local market circumstances. In particular, the entity could consider the interest rates currently charged by the entity or by others for loans with similar remaining maturities, cash flow patterns, currency, credit risk, collateral and interest basis. For example, very low interest rates on current accounts would be viewed as market rates if they are given in arm's length transactions.

Determining fair value

IAS 39.AG64

The fair value of low-interest and interest-free loans is the present value of the *expected* future cash flows, discounted using a market-related rate.

If the loan has no fixed maturity date and is available in perpetuity, then, in our view, discounting should reflect this assumption.

In our view, the fair value of an interest-free loan of which the lender can demand repayment at any time (i.e., a loan repayable on demand) is its face value and therefore discounting is not required.

We believe that loans that have no specified repayment date and that are not repayable on demand generally should be discounted based on expected future cash flows. However, if loans are repayable on demand, they are not discounted.

Short-term receivables and payables

IAS 39.AG79

Interest is required to be imputed when the impact of discounting would be significant. Therefore, in our view, receivables and payables with maturities of up to six months generally are not required to be discounted. However, in high-interest environments, the impact of discounting may be significant even for maturities of less than six months.

Accounting for differences between fair value and loan amount

IAS 39.AG64

Any difference between the cost and the fair value of the instrument on initial recognition is recognised as a gain or a loss unless it qualifies to be recognised as an asset or liability.

For example, if a low-interest loan is given in anticipation of a right to receive goods or services at favourable prices, the right may be recognised as an asset if it qualifies for recognition as an intangible asset (see 3.3) or other asset (e.g., prepaid expenses).

In our view, if the loan is from a shareholder acting in the capacity of a shareholder, the resulting credit normally should be reflected in equity, as the substance typically is a contribution by a shareholder (see 3.10).

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In our view, if the loan is from a government, the credit should be treated as a government grant (see 4.3).

Intra-group low-interest and interest-free loans

When low-interest or interest-free loans are granted to subsidiaries, the discounting effect must be eliminated on consolidation. Therefore, the discounting will be reflected only in the separate financial statements of the subsidiary and of the parent. In our view, in the individual financial statements of the investor, the discount should be recognised as an additional investment in the subsidiary.

Similar principles apply in the case of low-interest or interest-free loans to associates, except that the discounting effect on profit or loss will be eliminated only to the extent of the investor's interest in the associate when the equity method is applied (see 3.5).

Related party transactions

In our view, the requirement in IAS 39 to recognise all financial assets and liabilities at fair value applies to all low-interest or interest-free loans, including those to or from related parties. In addition, if the counterparty is a related party, related party disclosures will be required (see 5.5).

3.6.7 Subsequent measurement

IAS 39.46, 47 The following measurement requirements apply to all financial assets and financial liabilities. Financial assets and financial liabilities that are designated as hedged items may require further adjustment in accordance with the hedge accounting requirements (see 3.6.16).

Fair value through profit or loss

IAS 39.46, 55(a) These instruments are measured at fair value and all changes in fair value (realised and unrealised) are recognised immediately in the income statement.

Held-to-maturity assets

IAS 39.46(b) Subsequent to initial recognition, held-to-maturity assets are measured at amortised cost calculated using the effective interest method.

Loans and receivables

IAS 39.46(a) Subsequent to initial recognition, loans and receivables are measured at amortised cost calculated using the effective interest method.

Available-for-sale assets

IAS 39.46, 55(b) Available-for-sale assets are measured at fair value. Gains and losses on remeasurement of these assets are recognised directly in equity. For interest-bearing available-for-sale instruments, interest is calculated using the effective interest method and is recognised in the income statement (see 4.6). Foreign exchange gains and losses based on the amortised cost of an available-for-sale monetary item also are recognised in the income statement (see 3.6.11).

IAS 39.55(b) Amounts recognised directly in equity are transferred to the income statement when the asset concerned is sold (see 3.6.13), realised or impaired (see 3.6.12).

Liabilities

IAS 39.47 Subsequent to initial recognition, liabilities are measured at amortised cost calculated using the effective interest method except for those liabilities:

- measured at fair value through profit or loss (see 3.6.4); and
- that arise when a transfer of a financial asset does not qualify for derecognition and that are accounted for using the continuing involvement approach (see 3.6.13).

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3.6.8 Transfers between categories of financial assets

To or from fair value through profit or loss category

IAS 39.50 Transfers to or from the fair value through profit or loss category from or to any other category are prohibited.

Entities within the same group may undertake transactions in instruments classified in this category. From a consolidated perspective such instruments may not be reclassified out of the "fair value through profit or loss" category purely as a result of intra-group transactions, even if the instruments are not classified into this category by the acquiring group entity in its separate financial statements. For example, subsidiary A sells a debt instrument that it designated upon initial recognition as at fair value through profit or loss to subsidiary B; however, subsidiary B classifies that instrument as available-for-sale; the consolidated financial statements must continue to reflect that debt instrument as at fair value through profit or loss.

From held-to-maturity to available-for-sale

IAS 39.51 All held-to-maturity instruments are required to be reclassified to the available-for-sale category if there is tainting of the held-to-maturity portfolio (see 3.6.4).

IAS 39.55(b) Any adjustment on remeasurement from amortised cost to fair value on the date of the transfer is recognised directly in equity in the same category of equity as revaluations of available-for-sale instruments.

From categories of financial instruments measured at fair value to measurement at cost or amortised cost

IAS 39.54, 32.94(g) A transfer from the available-for-sale category to the held-to-maturity category is permitted once any tainting period has lapsed, or if there is a change in intent or ability. Otherwise, a reclassification to measure a financial instrument at cost that previously was measured at fair value is permitted only in the rare case when a reliable measure of the fair value no longer is available. The reason for any such transfers must be disclosed.

IAS 39.54 The fair value immediately prior to transfer becomes the "cost" in the new category.

For instruments carried at amortised cost, the difference between the newly established cost and the maturity amount is amortised over the remaining term of the financial asset using the effective interest method.

IAS 39.54 Any cumulative gains or losses related to the asset that previously were recognised directly in equity are transferred to the income statement over the period to maturity of the instrument as a yield adjustment or, if there is no stated maturity, when it is disposed of or impaired.

3.6.9 Fair value

IAS 39.9 39.AG71, 74, 39.IGE1.1 The overriding objective in measuring an instrument at fair value is to reflect the amount for which it could be sold in an arm's length transaction between knowledgeable willing buyers and sellers. Fair value excludes transaction costs.

Market prices

IAS 39.AG71 If an active market price is available, it must be used without adjustment to determine the fair value.

IAS 39.AG71 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. There is no further detailed guidance on how to determine whether there is an active market for a financial instrument. In our view, a market would be considered inactive only if there is very little trading volume or if significant trading volume is between related parties. Also, if there are restrictions on trading, then the market would be considered inactive.

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IAS 39.AG72 For purposes of initial measurement of financial assets and financial liabilities, the current market *bid* price must be used for liabilities incurred and the current *ask* price for financial assets acquired. For purposes of subsequent measurement of recognised financial assets and financial liabilities, the current market bid price must be used for financial assets held and the current ask price must be used for liabilities in issue. A mid-price may be used only when an entity has assets and liabilities with offsetting market risks and then only as a basis for establishing fair values for the offsetting risk positions. The net open position should be valued with reference to the bid or ask price as appropriate.

Problems often are encountered in reporting by investment funds, which offer linked investment products (i.e., when the fund's obligation to unit-holders is linked to the value of underlying investments). The investments held by the fund should be valued at bid price while, in the absence of a contractual agreement, the liability to unit-holders should be measured at the market ask price. If there is a contractual agreement between the entity and the unit-holders, then the liability should be valued in accordance with that agreement (e.g., mid-market). Owing to differences in the valuation basis of the investments and the unit liability respectively, a balance sheet mismatch results. This in turn causes a presentation issue. One solution to this problem may be to present the unit liability in a two-line format. The first line would be the value of the unit liability measured at mid-market, reflecting the actual price at which the unit is quoted at the balance sheet date, and the next line would include an adjustment for the difference between mid-market and bid prices. This reflects the fact that, for a fund with no equity, all recognised gains and losses must be attributed to unit-holders, which also means that, if all units were redeemed, a dilution levy of such amount would be required.

The above problem also may be encountered by other entities offering linked investment products such as insurance companies. We believe that the above approach also could be applied in these circumstances.

IAS 39.IGE2.2 A deviation from a published price in an active market is acceptable only if there is objective, reliable evidence that validates a different amount, for example, a contract to sell equity securities in the immediate future at a price that is different from the market price. Therefore, market prices are not adjusted for control premiums or discounts that may exist when an entity has a large holding of a particular instrument.

Valuation models

IAS 39.AG74 In the absence of an active market, fair value should be estimated using a valuation technique, which may include considering the price of a recent transaction in a similar instrument.

IAS 39.AG74-79 IAS 39 does not prescribe the method of calculating fair value. Various methods of determining fair values of financial assets and financial liabilities are discussed, and guidance is provided on valuation methods that may be appropriate in various situations.

There is no specific guidance in IFRSs on whether, in the absence of an active market, fair value should reflect exit or entry prices. In our view, to be consistent with the requirement to use bid (exit) prices for financial assets that are traded in an active market, fair value in the absence of an active market also should reflect exit prices. Similarly, we believe that fair value of liabilities in the absence of an active market should reflect entry prices.

IAS 39.AG81 In cases when the outcome of the valuation model is a range of estimates, the probabilities of the estimates within the range should be determined and applied to arrive at a single estimate of fair value. In our view, if different models are used and each model gives a different outcome, judgement should be used in determining which outcome is likely to be the most reliable. We do not believe that it is acceptable simply to average the outcomes of the various valuations.

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Valuation assumptions

IAS 39 does not prescribe whether the discount rate or the cash flows should be adjusted to reflect risk. For assets with specified cash flows, such as debt securities, an approach of adjusting the discount rate for risks inherent in the asset often is the best method. For other assets it may be more appropriate to adjust the expected cash flows and discount these at a risk-free interest rate.

IAS 39.AG82 In determining the inputs to valuation models, market information should be considered wherever possible. For example:

- A risk-free discount rate may be derived from government bond prices, which often are quoted. A well-accepted and readily observable general rate such as LIBOR also may be used as a benchmark rate.
- An appropriate credit spread may be derived from quoted prices for corporate bonds of similar credit quality to the instrument being valued, or rates charged to borrowers of a similar credit rating.
- Foreign currency rates usually are quoted in daily financial publications and electronic financial databases.
- Observable market prices are available for most commodities.
- Quoted market prices often are available for equity securities. For unquoted equity securities, valuation techniques based on discounted projected earnings may be used to estimate fair value.
- Measures of the volatility of actively traded items normally can be estimated reasonably on the basis of historical market data or by using volatilities implied in current market prices.

Immediate profit

In some cases, an entity acquires a financial instrument in one market and intends to sell it or to issue an offsetting instrument in a different market. An issue arises as to whether the instrument initially may be measured at its fair value in the selling market and therefore a gain recognised on initial recognition ("day one profit").

Similarly, an entity may believe that the initial fair value of an instrument exceeds the consideration paid or received, due to the entity's repackaging of the instrument or a built-in "fee". An issue arises as to whether this "fee" may be recognised immediately.

IAS 39.AG76 The best evidence of the fair value of a financial instrument at initial recognition is deemed to be the transaction price (i.e., the consideration paid or received), unless the fair value can be evidenced by comparison to other observable current market transactions in the same instrument, or is based on a valuation technique that uses only observable market data as inputs. Therefore, a gain may be recognised on the initial recognition of a financial instrument only if a fair value higher than the transaction price is calculated by reference only to market data.

In our view, when the application of the above requirements results in a gain not being recognised on initial recognition of an instrument, it is not appropriate to recognise the gain immediately on subsequent remeasurement of the instrument either.

Fair value exemption

IAS 39.46(c), 39.AG80, 81 The presumption in IAS 39 is that it is possible to determine a reliable estimate of the fair value of virtually all financial instruments. The only exception is for unlisted equity securities and derivatives linked to such securities, if there is no way of estimating fair value using a valuation technique within a reasonable range. Items for which fair value cannot be determined are measured at cost and onerous disclosures are required on an individual asset basis (see 5.6).

The exemption is very limited. It is unlikely that an investment would be purchased if its fair value cannot be estimated. In particular, venture capitalists and other entities that undertake significant investing activities use some form of valuation technique for the purpose of evaluating investment decisions. In our view, in these circumstances the same techniques used to make investment

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decisions should be used to determine subsequently the fair value of investments. The exemption may be used only in rare cases when it can be demonstrated that the valuation technique generates a wide range of possible fair values, and when the probability of the various outcomes cannot be estimated.

Valuation of investment funds

Many venture capital entities use industry valuation guidelines. In our view, although the valuation determined using these methods may be used as a starting point in determining fair value, adjustments normally are required to the valuation derived in order to determine a fair value measurement that is compliant with IAS 39. This is because valuations using these models often result in a more conservative measure of value than current market-based fair value – the objective of fair value measurement under IAS 39.

An issue sometimes arises as to whether an investment in a fund can be valued reliably. In our view, if the fund invests in marketable securities, then the investment in the fund can be valued. In most cases, even if the fund invests in unlisted entities, it should be possible to determine a valuation of the investment in the fund.

In our view, if the valuation reported by the fund (e.g., based on the net asset value of the fund) represents the amount at which the interest in the fund could be exchanged in an arm's length transaction, then this value should be used for the valuation of the investment.

If the valuation reported by the fund does not represent the amount at which an arm's length transaction would occur, then the value of the investment in the fund should be determined by applying a valuation technique to the fund's underlying investments.

In some cases a fund invests in another fund. In our view, in this case the same principles apply. Therefore, if a fair value is not available for the investment in the fund directly, then an attempt should be made to value the underlying investments in the underlying fund. Only in the rare circumstances that the value of these underlying investments cannot be estimated reliably would it be acceptable to measure the interest in the fund at cost.

Refer to the discussion under *Market prices* above regarding the balance sheet mismatch arising from differences in valuation between the investments of an investment fund and its liability to unit-holders.

Choosing to measure an instrument at fair value

IAS 39.9 As noted in 3.6.4, any financial instrument may be designated as an instrument measured at fair value with changes in fair value recognised in profit or loss.

IAS 39.9, 50 The designation is made on initial recognition on an instrument-by-instrument basis. There is no requirement for similar instruments to be designated consistently. However, caution should be exercised before classifying an instrument into this category because the designation is irreversible. Once an instrument is designated it can never be classified out of the fair value through profit or loss category.

IAS 39.48, 39.AG69-82 Also, when an instrument is designated into this category it must be measured at fair value with respect to *all* the risks inherent in the instrument. It is not acceptable to measure an instrument at fair value only with respect to certain of its risk components (e.g., benchmark interest rate risk but not credit risk).

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Examples of instruments that an entity may wish to measure at fair value with changes in fair value reported in the income statement include:

- Instruments that contain an embedded derivative. This eliminates the burden of having to evaluate and, if required, separate the embedded derivative (see 3.6.15).
- Liabilities that fund a trading portfolio. This eliminates the mismatch that otherwise would arise between the measurement of the liabilities and the related assets.
- Available-for-sale financial assets, held-to-maturity assets, loans and receivables or liabilities that are hedged with respect to interest rate risk using a derivative. This results in a matching accounting treatment for the derivative and the hedged item and eliminates the need to meet the stringent criteria and perform the complex accounting adjustments that are required for hedge accounting (see 3.6.16).
- Matching asset and liability positions. This achieves matching accounting treatment.

This area of IFRSs may be subject to future developments (see 3.6.19).

3.6.10 Amortised cost

IAS 39.9

Amortised cost must be calculated using the effective interest rate method. For guidance on applying the effective interest rate method (see 4.6).

Applying the amortised cost method, interest is recognised in the income statement in the period to which it relates, regardless of when it is to be paid. Therefore, interest is recognised in the period in which it accrues, even if payment is deferred.

3.6.11 Foreign currency denominated financial instruments

The principles for foreign currency transactions explained in 2.7 apply to financial instruments. The application of these principles to various foreign currency denominated financial instruments is explained below.

Monetary items carried at amortised cost

IAS 21.23(a), 21.28, 39.AG83, 39.IGE3.4

Monetary items denominated in a foreign currency and carried at amortised cost (i.e., loans and receivables, held-to-maturity investments and other liabilities) are measured as follows:

- The functional currency carrying amount at the beginning of the period (i.e., the amount reported in the functional currency of the entity at the previous balance sheet date) is the starting point.
- The interest to recognise in the period is the amount calculated in the foreign currency using the effective interest rate method multiplied by the average spot exchange rate for the period. This accrual adjusts the functional currency carrying amount at the beginning of the period.
- The foreign currency amortised cost of the monetary item then is calculated as at the end of the period.
- The functional currency carrying amount at the end of the period is the above foreign currency amortised cost multiplied by the spot exchange rate at the balance sheet date.
- The functional currency carrying amount as calculated above then is compared to the functional currency carrying amount at the beginning of the period adjusted for the interest accrual. Any difference between these two amounts comprises an exchange gain or loss, which is recognised in the income statement.

Available-for-sale monetary items

IAS 21.23(a), 28, 39.AG83, 39.IGE3.2, 3.4

For the purpose of recognising foreign exchange differences, available-for-sale monetary items, such as debt securities, are treated as if they were carried at amortised cost in the foreign currency. Accordingly, the foreign exchange differences arising from changes in amortised cost must be recognised in the income statement and not directly in equity.

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The foreign currency differences on these instruments are measured as follows:

- The functional currency amortised cost at the beginning of the period (i.e., the amount calculated (but not reported) in the functional currency of the entity at the previous balance sheet date) is the starting point.
- The interest to recognise in the period is the amount calculated in the foreign currency on the effective interest rate method multiplied by the average spot exchange rate for the period. This accrual adjusts the functional currency amortised cost at the beginning of the period. Note that for such available-for-sale monetary items, interest calculated on the effective interest rate method is required to be recognised in the income statement (see 3.6.7).
- The foreign currency amortised cost of the monetary item then is calculated as at the end of the period.
- The functional currency amortised cost at the end of the period is the above foreign currency amortised cost multiplied by the spot exchange rate at the balance sheet date.
- The functional currency amortised cost at the end of the period then is compared to the functional currency carrying amount at the beginning of the period adjusted for the interest accrual. Any difference between these two amounts comprises an exchange gain or loss, which is recognised in the income statement.

The reported carrying amount of such available-for-sale monetary items then is calculated as follows:

- The fair value of the monetary item at the end of the period should be calculated in the foreign currency.
- The functional currency carrying amount at the end of the period is determined by multiplying the fair value in the foreign currency by the exchange rate at the balance sheet date.
- The difference between the functional currency carrying amount at the end of the period (i.e., fair value) and the functional currency amortised cost at the end of the period, comprises the cumulative gain or loss to be recognised directly in equity at the end of the year.

In our view, the liability component of a convertible bond should be considered to be a monetary item.

IAS 39.IGE3.2

For example, on 31 December 2003 entity A acquires a bond denominated in US dollars ($) for its fair value of $1,000. The bond has five years remaining to maturity and a principal amount of $1,250, carries fixed interest of 4.7 per cent that is paid annually ($1,250 x 4.7 per cent = $59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available for sale, and thus recognises gains and losses in equity. The entity's functional currency is euro (€). The exchange rate is $1 to €1.5 and the carrying amount of the bond is €1,500 ($1,000 x 1.5). Entity A recognises the bond initially as follows:

	Debit	*Credit*
Bond	€1,500	
Cash		€1,500

On 31 December 2004, the foreign currency has appreciated and the exchange rate is $1 to €2. The fair value of the bond is $1,060 and thus the carrying amount is €2,120 ($1,060 x 2). The amortised cost is $1,041 (€2,082). In this case, the cumulative gain or loss to be recognised directly in equity is the difference between the fair value and the amortised cost on 31 December 2004, i.e., a gain of €38 (€2,120 - €2,082).

Interest received on the bond on 31 December 2004 is $59 (€118). Interest income determined in accordance with the effective interest method is $100 (1,000 x 10 per cent). The average exchange rate during the year is $1 to €1.75. Thus, reported interest income is €175 ($100 x 1.75) including

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accretion of the initial discount of €72 (($100 - $59) x 1.75). Accordingly, the exchange difference on the bond that is recognised in profit or loss is a gain of €510 (€2,082 - €1,500 - €72). Also, there is an exchange gain on the interest receivable for the year of €15 (€59 x (2.00 - 1.75)).

	Debit	*Credit*
Bond	€620	
Cash	€118	
Interest income		€175
Exchange gain		€525
Fair value change in equity		€38

Non-monetary items measured at fair value

IAS 21.30, 39.AG83 There is no distinction between fair value adjustments and exchange differences on non-monetary items, such as investments in equity securities.

The functional currency carrying amount is determined by multiplying the fair value in the foreign currency by the spot exchange rate at the balance sheet date. The full adjustment to the carrying amount is treated as a change in fair value and reported in the income statement or in equity, depending on the classification of the instrument.

3.6.12 Impairment of financial assets

IAS 36.2(e), 39.58 The impairment requirements of IAS 39 must be applied to determine bad debt losses on loans and receivables and impairment losses on available-for-sale and held-to-maturity debt and equity securities.

IAS 39.58 At each balance sheet date it is necessary to assess whether there is objective evidence that any financial asset not measured at fair value through profit or loss is impaired or uncollectible. If there is any objective evidence that such an asset is impaired, the amount of any impairment loss must be calculated.

Triggers of an impairment calculation

IAS 39.59 Evidence that a financial asset may be impaired includes:

- significant financial difficulty of the issuer;
- payment defaults;
- renegotiation of the terms of an asset due to financial difficulty of the borrower;
- significant restructuring due to financial difficulty or expected bankruptcy;
- disappearance of an active market for an asset due to financial difficulties; or
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since their initial recognition, although the decrease cannot yet be identified with the individual assets in the group.

Recognition of an impairment loss is not restricted to situations in which the loss is considered to be permanent.

Debt securities

IAS 39.60 A debt security is impaired if there is an indication that the originally anticipated cash flows from the instrument are not recoverable. Therefore, a decline in the fair value of a debt instrument due to changes in market interest rates is not in itself an indication of impairment. For example, the fair value of a fixed rate debt security would decrease if market interest rates increased. This is not evidence of impairment if the contractual cash flows associated with the debt security are recoverable.

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Equity securities

IAS 39.61 Under IAS 39 a significant *or* prolonged decline in the fair value of an equity security below its cost *must* be considered objective evidence of impairment. In our view, there is no ability to override this evidence based on qualitative factors. However, if a decline in the fair value is not significant or prolonged it still is necessary to consider if there are other factors that indicate impairment (see additional guidance below).

In our view, an entity should establish accounting policies that it applies consistently to determine whether a decline in a quoted market price is significant or prolonged. IFRSs do not contain any specific quantitative thresholds for "significant" or "prolonged". In our view, for equity securities that are quoted in an active market, applying the general concepts of significance and materiality. We believe that a decline in excess of 20 per cent always should, except in very rare cases, be regarded as significant. In our view, a decline in a quoted market price that persists for nine months generally should be considered to be "prolonged". However, it may be appropriate to consider a shorter period than nine months to be prolonged.

In our view, if an estimate of fair value triggers an entity's established thresholds for "significant" or "prolonged", then the entity can consider qualitative factors to determine whether that estimate of fair value should be revised.

If a decline in fair value is significant or prolonged then there is objective evidence of impairment and an impairment loss must be recognised, regardless of for how long management intends to hold the investment. Therefore, if there has been a significant or prolonged decline in the market price at the balance sheet date, an impairment loss should be recognised, even if the prospects of recovery are good and this is evidenced by an increase in the share price after the balance sheet date.

Following the guidance for events after the balance sheet date (see 2.9), a change in market value subsequent to the balance sheet date normally reflects circumstances that have arisen subsequently. In rare cases it may be possible to demonstrate that an increase in market value subsequent to the balance sheet date results directly from new information about conditions existing at the balance sheet date that was not available to the market at that date.

For example, an entity may enter into a transaction before its reporting date but, for reasons of the counterparty's confidentiality, be prohibited by the agreement from announcing the transaction until after its reporting date. The share price may have shown a significant or prolonged decline prior to the reporting date and recovered subsequently as a result of the announcement of the transaction. It would be necessary to demonstrate that both the decline and the subsequent recovery of the share price were directly related to the announcement. In our view, this would be extremely rare.

IAS 39.61 In our view, in evaluating whether a decline in fair value is significant in periods after an impairment loss has been recognised, the extent of the decline should be considered in relation to the *original cost* of the instrument, not its recoverable amount at the date that the impairment loss was recognised. Similarly, we believe that evaluation of whether a decline in fair value is prolonged should consider the entire period for which the investment has been held, and not just the period since an impairment loss was recognised.

IAS 39.61 If a decline in the fair value of an equity security is not significant or prolonged, then an investor must consider if there are additional factors that indicate an impairment has occurred. In our view, this assessment should be performed for all equity securities whose fair value is below cost, but for which the decline in fair value is not considered significant or prolonged. This assessment requires consideration of all the facts and circumstances. Therefore, even if a decline in the market price of an equity security does not meet the entity's established thresholds for "significant" or "prolonged", the equity security still may be impaired based on a consideration of other factors. In our view, the higher

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or longer that the entity's thresholds for determining whether a decline is significant or prolonged, the more comprehensive the subjective evaluation needs to be.

In addition to the impairment indicators listed above, factors that may indicate an impairment loss for an equity security include significant adverse changes in the environment in which the issuer of equity securities operates, as this may indicate that the cost of the investment may not be recovered.

Generally, we would expect an equity security to become impaired earlier than a debt security issued by the same counterparty due to the nature of each instrument and the rights each conveys to its holder.

Portfolios of assets

IAS 39.59(f) A decrease in the estimated cash flows from a group of financial assets usually indicates impairment of that group of assets. Evidence of a decrease in estimated cash flows from a group of assets includes:

- an adverse change in the payment status of borrowers in the group (e.g., an increased number of customers exceeding their credit limit or not making payments on time); or
- a change in national or local economic conditions that is likely to cause higher defaults on payments.

Impairment loss calculations

Loans and receivables and held-to-maturity assets

IAS 39.63 The impairment loss recognised in the income statement is the difference between the carrying amount and the recoverable amount of the asset.

IAS 39.63 The recoverable amount is calculated by discounting the estimated probable future cash flows at the *original* effective interest rate (i.e., the rate that is used to accrete interest).

In our view, for a floating rate instrument that is carried at amortised cost, the current effective interest rate should be used to discount the estimated cash flows.

Available-for-sale assets

IAS 39.67, 68 The basis for any write-down as a result of an impairment loss for an available-for-sale asset is its fair value.

Any previous net upward revaluation in equity in respect of the asset is reversed first. Any additional write-down below the initial amount recognised for the asset should be recorded as an impairment loss in the income statement.

IAS 39.68 If the asset previously was revalued through equity to an amount below its original recorded amount, the closing net debit balance in the revaluation reserve in respect of that asset should be reversed from equity and recognised as an impairment loss in the income statement. The entire amount of the revaluation below original cost must be recognised as an impairment loss even if the estimated recoverable indicates that some of that decline is recoverable.

Assets carried at cost because fair value is not reliably measurable

IAS 39.66 The amount of any impairment loss to be recognised in the income statement related to financial assets carried at cost because their fair value is not reliably measurable, (i.e., certain unquoted equity instruments and derivatives linked to such instruments) is measured as the difference between the carrying amount and the present value of estimated future cash flows discounted at the *current market rate* of return for a similar financial asset.

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Hedged assets

IAS 39.IGE4.4 The principles for recognition of an impairment loss apply equally to an asset that is the hedged item in a qualifying hedge relationship (see 3.6.16.). In a fair value hedge, both the original effective interest rate and the amortised cost of the hedged item are adjusted to take into account recognised changes in fair value attributable to the hedged risk. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan. The impairment assessment should be based on the carrying amount of the asset after any adjustments as a result of applying hedge accounting, which is compared to the estimated future cash flows of the hedged item discounted at the adjusted effective interest rate (not the original effective interest rate).

Collateral

IAS 39.AG84 If an impaired financial asset is secured by a guarantee or collateral, then the estimation of the impairment loss of the asset should reflect the cash flows that may result from foreclosure, whether or not foreclosure is probable.

IAS 39.IGE4.8 If foreclosure is probable, impairment is based on the fair value of the collateral (guarantee) less costs of obtaining the collateral (guarantee). However, in our view, a gain should not be recognised, even if the collateral is expected to have a higher value than the carrying amount of the loan.

On the date of foreclosure, in our view, any collateral received initially should be measured based on the carrying amount of the defaulted loan. Thereafter, it should be accounted for under the relevant standard.

Reversals of impairment losses

Loans and receivables and held-to-maturity assets

IAS 39.65 If, after an impairment loss has been recognised, the amount of any impairment loss of a loan or receivable or held-to-maturity asset decreases due to an event occurring subsequent to the write-down, then the previously recognised impairment loss is reversed through the income statement with a corresponding increase in the carrying amount of the underlying asset. The reversal is limited to an amount that does not state the asset at more than what its amortised cost would have been in the absence of an impairment.

Available-for-sale assets

IAS 39.68, 69 Impairment losses on an available-for-sale *equity instrument* may not be reversed through the income statement. Any increase in the fair value of an available-for-sale equity instrument after an impairment loss has been recognised is treated as a revaluation and is recognised directly in equity.

IAS 39.70 An impairment loss on an available-for-sale *debt instrument* is reversed through the income statement if there is evidence that the increase in fair value is due to an event that occurred after the impairment loss was recognised.

Assets carried at cost because fair value is not reliably measurable

IAS 39.66 Impairment losses on assets carried at cost because their fair value is not reliably measurable may not be reversed.

Portfolio impairment assessment

IAS 39.58, 59, 64 Assets carried at amortised cost that are not individually significant are assessed for impairment as part of a portfolio.

IAS 39.64, 39.IGE4.7 Any significant asset within a portfolio first must be assessed for impairment individually if there is an indication that it is impaired. If the asset is found not to be impaired, it should be included in the relevant portfolio for the purpose of any impairment test of that portfolio. If the asset is found to be impaired it should not be included in a portfolio for the purpose of any impairment test of that portfolio.

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IAS 39.AG87

Assets may be grouped for portfolio tests of impairment only if the assets share similar credit risk characteristics. Groups of assets that share similar credit risk characteristics may be identified based on:

- credit risk grades;
- types of loan;
- geographic location of the borrower;
- type of collateral;
- type of counterparty;
- aging profile; and / or
- maturity.

IAS 39.AG89-92, 39.IGE4.6

The objective of the portfolio impairment test is to identify losses that have been incurred, but not yet identified, on a specific asset basis. IFRSs prohibit recognising an impairment for expected future losses. Historical experience, supported by observable data, adjusted for current conditions, is used to determine the amount of the losses that have been incurred in a portfolio but have not yet been identified with specific items within the portfolio.

The approach to assessing impairment with respect to non-performing loans differs from that in respect of performing loans. When loans are identified as non-performing, depending on the individual significance of each loan, the impairment assessment may be carried out individually or collectively. For example, a portfolio of motor vehicle loans, all of which have been identified as possibly impaired owing to being outstanding for periods in excess of 90 days (the entity's defined trigger event), would be assessed collectively for impairment if individually they are not significant. The collective impairment assessment would take into account the historical loss experience in respect of these or similar assets. With respect to performing loans the approach used in assessing impairment should be aimed at minimising detection risk (i.e., the risk that a loss, which has been incurred but not yet reported, will not be detected). In contrast, the assessment of non-performing loans for impairment is not subject to detection risk since these loans already have been identified as possibly being impaired.

Bad debts and loan losses

IAS 39.63, 39.AG90-93, 39.IGE4.2, 5, 6

The following practices related to bad debt losses are not acceptable under IAS 39:

- Recognising a provision for losses based on a set percentage of receivable balances having certain characteristics (e.g., according to the number of days overdue) rather than actual incurred losses, unless these percentages are validated using historical data.
- Recognising a loss for the gross expected shortfall on non-performing assets, and suspending interest accrual. The calculation of an impairment loss must be based on discounted estimated cash flows. This results in an impairment loss being recognised to measure the asset at the present value of the estimated future cash flows. In subsequent periods, interest must continue to be accrued on the net carrying amount using the effective interest rate method. The effective interest rate for such an asset is the rate that was used to discount the estimated cash flows for the purposes of calculating the impairment loss of the asset.
- Recognising a provision in excess of incurred losses calculated based on estimated cash flows, even if local regulations require a specific amount to be set aside ("general risk provisions"). In our view, if an entity wishes to set aside amounts in addition to the impairment losses calculated under IAS 39, it may do so by transferring amounts from retained earnings to a separate category of equity, for example, a loan loss reserve (see 3.10). It is not acceptable to recognise any amounts in the income statement or to reduce the carrying amount of the assets in excess of the adjustment calculated as described above.

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3.6.13 Derecognition of financial assets

Transfers of financial instruments, in particular receivables and loans and advances, are common. Examples of such transactions are securitisations and factoring arrangements. IAS 39 provides detailed derecognition principles for financial assets.

IAS 39.15 In consolidated financial statements the derecognition criteria are applied at a consolidated level. Therefore, if financial instruments are transferred within a group, then the consolidated financial statements will not reflect derecognition for inter-group transfers, including transfers to consolidated special purpose entities (see 2.5), even if the transaction qualifies for derecognition in the separate financial statements of the transferor.

Derecognition criteria

IAS 39.17, 20 To achieve derecognition, the contractual rights to the cash flows from an asset must expire or the entity must transfer a financial asset and certain criteria must be met with respect to that transfer.

IAS 39.20 After establishing that a financial asset is transferred, consideration should be given to whether that transfer qualifies for derecognition, namely:

- If substantially all of the asset's risks and rewards are transferred, then a financial asset is derecognised. If substantially all of the asset's the risks and rewards are retained, then the asset is not derecognised.
- If some but not substantially all of the asset's risks and rewards are transferred, then an asset is derecognised if control of the asset is transferred.
- If some but not substantially all of the asset's risks and rewards are transferred, then an asset is not derecognised if control of the asset is not transferred, and the entity continues to recognise the transferred asset to the extent of its continuing involvement in the asset.

Evaluating whether there is a transfer

IAS 39.18 An entity is considered to have transferred a financial asset, or a part thereof, if the entity:

- transfers its rights to receive the cash flows from the asset; or
- retains the rights to receive the cash flows but assumes a contractual obligation to pay the cash flows to one or more recipients.

IAS 39.19 When an entity retains the contractual right to the cash flows, but also assumes a contractual obligation to pay the cash flows to the transferee (sometimes called a "pass-through arrangement") the transaction is considered a transfer only if:

- there is no obligation to pay amounts to the transferee unless the entity collects equivalent amounts from the original asset;
- the entity is prohibited from selling or pledging the original asset under the terms of the pass through arrangement; and
- the entity is obliged to remit all cash flows it collects without material delay.

For example, A enters into an agreement with B regarding a security owned by A. Physical custody of the security is retained by A, but A agrees to pass any cash flows generated by the security to B immediately. There is no obligation for A to pay any amount to B other than the cash it receives on the security. The agreement prohibits A from selling the security. The transaction qualifies as a transfer and should be evaluated under the derecognition principles.

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Risks and rewards evaluation

IAS 39.20(a), (b) For all transactions that qualify as a transfer of a financial asset, or part thereof, the entity next must consider if it has transferred or retained the risks and rewards of ownership of the financial asset:

- If the entity retains substantially all of the risks and rewards of ownership of the financial asset, then it should continue to recognise the financial asset.
- If the entity transfers substantially all of the risks and rewards of ownership, then it should derecognise the entire asset.
- If the entity neither transfers, nor retains, substantially all of the risks and rewards of ownership, then it should determine whether it has retained control of the financial asset.

IAS 39.21 No specific quantitative guidance is provided on what constitutes "substantially all" of the risks and rewards of an asset and there is no specific precedent in practice. In our view, the analysis should be based on all of the facts and circumstances considering all of the risks associated with the asset on a probability-weighted basis. The analysis should not consider each risk in isolation. If substantially all of the total variability in the present value of the future cash flows associated with the asset is retained, then the entity would, in our view, be considered to have retained substantially all of the risk.

IAS 39.AG40(e) For example, P transfers short-term receivables of 100,000 to Q. P provides a guarantee of 10,000. Expected total credit losses are 5,000. P retains substantially all of the risk associated with the receivables because it retains the risk of all of the reasonably expected losses. Therefore, P has not transferred substantially all of the risks *and* rewards of the 100,000 and the receivables should not be derecognised by P.

In some cases, a third party provides credit insurance. In our view, if the transferor is the beneficiary of the insurance contract, but agrees to compensate the transferee for credit losses, this is an indication that the transferor has retained the credit risk. In this case, in evaluating whether the assets qualify to be derecognised, the insurance contract should be disregarded and it should be assumed that the transferor continues to bear the credit risk.

IAS 39.AG51(e) An entity may sell a financial asset and immediately purchase an identical asset (a so called "wash sale"). As long as there is no agreement at the time of the sale to purchase the asset, and the purchase is at fair value, the sale and the purchase should be treated as two separate transactions. Therefore, the original asset would be derecognised provided that the remaining derecognition criteria are met. The fact that the transferor expects to acquire an identical replacement asset is not a sufficient basis for concluding that the transferor has retained the risks and rewards in the absence of a contractual commitment to repurchase the transferred asset.

Control evaluation

IAS 39.20(c) If the entity neither transfers nor retains substantially all of the risks and rewards of ownership of the financial asset, then the entity should determine if it retains control of the financial asset, or control of some part of the asset.

For example, if V transfers long-term mortgage receivables to W and retains the credit risk, but transfers prepayment risk and interest rate risk, V has retained some of the risk and transferred some of the risk. When compared with each other, it is assumed that neither the credit risk nor the combined prepayment risk and interest rate risk is considered to be more significant. Therefore, V should determine if it retains control of the receivables.

IAS 39.23, 39.AG43 An entity is considered to have lost control if the transferee has the practical ability to sell the asset unilaterally without needing to impose additional restrictions on the transfer. If there is a market for the asset (i.e., if the asset is readily obtainable), then the transferee often has the practical ability to sell the asset, even if the contractual arrangements between the transferor and the transferee restrict

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a sale. Conversely, the transferee usually does not have the practical ability to sell the asset if there is no market for the asset, even if the contractual arrangements between the transferor and transferee permit a sale. As a result, in the latter case the entity would not be considered to have lost control.

IAS 39.20(c)(i)

An entity derecognises a financial asset if it transfers substantially all of the risks and rewards of ownership of an asset, or transfers some, but not substantially all, of those risks and rewards and it does not retain control of the asset.

Continuing involvement

IAS 39.20(c)(ii)

If the entity retains control of an asset for which some risks have been transferred, the entity should continue to recognise the financial asset to the extent of its continuing involvement in the financial asset.

IAS 39.AG48

For example, P transfers short-term receivables of 100,000 to Q. P provides a credit loss guarantee of 2,000. Expected credit losses are 5,000. Q is not permitted to sell or pledge the receivables. In our view, P has retained some, but not substantially all, of the risks and rewards of ownership associated with the receivables. Therefore, P should evaluate whether it has lost control. Q is not permitted to sell or pledge the receivables and there is not a market for such receivables. Therefore, P has not given up control and should continue to recognise the receivables to the extent of its continuing involvement. The maximum extent of P's continuing involvement is 2,000 (the amount of the guarantee). Therefore, P should derecognise 98,000 and continue to recognise 2,000.

Accounting for a sale

Transfers that qualify for derecognition

IAS 39.27

Sometimes only part of an asset qualifies to be derecognised (e.g., if an interest-only strip or servicing right is retained). In these cases, the carrying amount of the entire asset before the transfer is allocated between the sold and retained portions based on their relative fair values on the date of the transfer.

IAS 39.24, 25

Sometimes new assets or liabilities are created in the transfer (e.g., a servicing liability on transferred loans or a credit guarantee). New assets or liabilities created as a result of the transfer are recognised separately and measured at fair value.

IAS 39.26, 27

A gain or loss is recognised based on the difference between the carrying amount of the asset or portion of the asset transferred, and the sum of the proceeds received, including the fair value of any new assets acquired or liabilities assumed in the transfer, and the cumulative amount previously recognised directly in equity in respect of the transferred asset, or the portion of the transferred asset.

If financial instruments are exchanged in a transaction that meets the criteria for derecognition, the financial assets received initially should be measured at fair value and the profit or loss on disposal should be calculated based on the fair value of the assets received.

IFRSs are silent on how to determine the cost of financial assets sold when the assets are part of a homogenous portfolio. Therefore, the application of the hierarchy for selecting accounting policies in the absence of a standard (see 2.8) should be applied. In our view, the guidance in IAS 2 regarding cost formulas should be applied (see 3.7). Therefore, any reasonable cost allocation method (e.g., average cost or FIFO) may be used, although we prefer the average cost method. The method used should be applied consistently and disclosed in the accounting policy notes. It should be noted that the approach used to determine the cost of financial assets sold should be applied consistently when assessing impairment and accounting for resulting impairment losses.

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Trade or settlement date accounting

IAS 39.AG53 Regular way sales of securities are recognised on trade or settlement date, consistent with the accounting policy for purchases for financial assets in the same category (see 3.6.5).

IAS 39.AG55 If trade date accounting is applied, the asset is derecognised and the profit or loss on disposal and a receivable for the sales proceeds are recognised on trade date.

IAS 39.AG56 If settlement date accounting is applied, the asset continues to be recognised until the settlement date, although no changes in its fair value are recognised. On the settlement date, the asset is derecognised and a profit or loss on the disposal is recognised. The proceeds are the contract amounts; the carrying amount of the assets sold will not reflect gains and losses between the trade and settlement date.

IAS 39.IGD2.2 The difference between trade date and settlement date accounting for a sale of financial instruments is in the timing of derecognition of the transferred instruments and of recognition of any profit or loss on disposal. Changes in the value of an asset between trade date and settlement date are attributable to the purchaser. Therefore, if the instrument is carried at fair value, the seller stops recognising changes in value from the trade date, regardless of which method is applied.

Transfers not qualifying for derecognition

IAS 39.20, 39.AG47 If a transfer does not qualify for derecognition, then the asset, or the retained portion of the asset, remains recognised on the balance sheet and a corresponding liability is recognised for any consideration received. Disclosure of the fact that the asset is pledged as collateral for the liability is required (see 5.6). Collateralised assets may be shown as a separate category, if significant.

Transfers to SPEs

When financial instruments are transferred to a special purpose entity (SPE), additional considerations arise.

- Must the SPE be consolidated applying the risks and rewards approach in SIC–12 (see 2.5)?
- Does the SPE transfer control of the assets, or components of the assets, to third party investors and therefore qualify to derecognise the financial assets or portions of the assets?

Transferred assets will be derecognised in the consolidated financial statements only if the SPE's transfer of the assets to third parties is a transaction that qualifies for derecognition under IAS 39.

Repurchase agreements and securities lending

IAS 39.AG51(a) If a sale of a financial asset is subject to a repurchase agreement at a fixed price, or at the initial selling price plus interest, or if the asset is lent to a third party who agrees to return it, then the seller retains substantially of all the risks and rewards of ownership of the asset. Therefore, the seller does not derecognise the asset. If the transferee obtains the right to sell or pledge the asset, then the seller reclassifies the asset on its balance sheet, for example, as a loaned asset or repurchase receivable.

IAS 39.AG51(b), 39.AG51(c) This treatment applies regardless of whether the asset subject to the agreement is readily obtainable in the market, such that the transferee could repurchase the asset in the market in order to meet its return obligation to the seller, or the returned asset is required to be the same or substantially the same, when the terms of the repurchase agreement provide as such.

IAS 39.AG50 Similarly, the transferee should not recognise the asset received under a repurchase or securities lending arrangement. If the transferee sells the asset, then it should recognise a liability to return the asset based on the fair value of the asset.

If there is an event of default by the seller, the seller should derecognise the asset and the transferee should recognise the asset at fair value and derecognise the liability to return the asset.

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3.6.14 Derecognition of financial liabilities

IAS 39.39, 39.AG57, 59

A liability is derecognised when it is extinguished (i.e., it is discharged, cancelled or expires). This may happen when:

- payment is made to the lender, for example, when the issuer of a debt instrument redeems the instrument;
- the borrower is released legally from primary responsibility for the liability. This condition can be satisfied even if the borrower has given a guarantee as long as the borrower is released from primary responsibility. But payment to a third party, for example, an in-substance defeasance trust, does not result in legal release unless the creditor releases the original debtor from the primary obligation; or
- there is an exchange of debt instruments with substantially different terms.

Modification of terms

Issues surrounding whether it is appropriate to derecognise a financial liability often arise when the terms of a liability are renegotiated, for example, when the borrower experiences financial difficulty.

IAS 39.40

When a liability is restructured or refinanced and the terms have been modified substantially, the transaction is accounted for as an extinguishment of the old debt, with a gain or loss. The new debt is recognised at fair value.

IAS 39.AG62

Terms are considered to have been modified substantially when the net present value of the cash flows under the new terms, using the original effective interest rate (i.e., of the original liability) differs by more than 10 per cent from the present value of the remaining payments under the original terms.

A modification of the terms of a liability may give rise to embedded derivatives, such as early settlement options, that will result in a significant loss to the lender if exercised. Any such embedded derivatives need to be analysed to determine whether they should be accounted for separately (see 3.6.15).

Troubled debt restructurings

There are no special requirements for troubled debt restructurings under IFRSs. The above rules on modifications of liabilities apply whether or not the borrower is experiencing financial difficulties.

Accounting for derecognition

IAS 39.41

The difference between the amount paid in settlement including any non-cash assets transferred or liabilities assumed and the carrying amount of the liability is recognised as a gain or loss in the income statement.

In our view, in the case of forgiveness of debt, the accounting treatment should be based on an analysis of the nature of the transaction. If a shareholder forgives the debt, it is likely that the shareholder is acting in the capacity of a shareholder and that the forgiveness of debt should be treated as a capital transaction. The outstanding liability should be reclassified to equity and no gain or loss should be recognised (see 3.10). In cases when there is clear evidence that the shareholder is acting as a lender, in the same way as an unrelated lender, the gain or loss should be recognised in the income statement (with related party disclosures, see 5.5). If a government forgives a loan, then the forgiveness should be treated as a government grant (see 4.3) unless the government also is a shareholder and is acting in that capacity.

IFRSs do not specify where a gain or loss on the extinguishment of debt should be presented in the income statement. In our view, it should be included within financial income or expense (see 4.6).

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3.6.15 Embedded derivatives

In order to ensure that the general principle of measuring derivatives at fair value and reporting changes in fair value in the income statement is not avoided, a derivative that is attached to another item (a host contract) must be treated like a stand-alone derivative under certain conditions. Derivatives may be embedded in other financial instruments, for example, convertible bonds, or non-financial items such as contracts for the receipt or delivery of other goods or services.

Definition

IAS 39.10 Embedded derivatives are terms of a contract or instrument that behave like a derivative. For example, a debt security pays interest of LIBOR plus a factor that varies depending on the oil price. The security is economically equivalent to a debt instrument and a series of forwards on the oil price. The forwards on the oil price are embedded derivatives.

IAS 39.10, 39.IGC6 A derivative contract attached to a host contract that is transferable separately from the host contract or that is added by a third party is a stand-alone derivative (see 3.6.3), and not an embedded derivative. For example, a finance lease or loan may have an associated interest rate swap. If the swap can be sold separately, it is a stand-alone derivative, and not an embedded derivative, even if the derivative and the host contract both have the same counterparty. Similarly, each component of a "synthetic instrument" is accounted for separately. A synthetic instrument comprises a combination of separate instruments that, viewed together, 'create' a different instrument. For example, entity A holds a five-year floating rate debt instrument and a five-year pay floating, receive fixed interest rate swap; together these two instruments create, for entity A, a synthetic five-year fixed rate investment. The individual components of synthetic instruments are not embedded derivatives.

A single derivative that has a number of component parts is not separated into its component parts. The instrument as a whole is treated as a derivative.

Although lease contracts and insurance contracts generally are excluded from the scope of IAS 39, derivatives embedded in these contracts are subject to the requirements for separation of embedded derivatives. However, an embedded purchase option for the leased asset included in a lease contract should not be separated since such an option is accounted for as part of the lease (see 5.1). All other derivatives embedded in lease contracts (e.g., foreign currency derivatives, leveraged escalation clause etc.) should be considered for separation.

When to separate

IAS 39.11 Derivatives that are embedded in a host contract should be accounted for separately as derivatives if they are not closely related to the host contract, unless the hybrid (combined) instrument is measured at fair value with changes in fair value recognised directly in the income statement.

IAS 39.IGC3 Fair value adjustments on available-for-sale instruments are reported directly in equity, therefore derivatives embedded in available-for-sale instruments are required to be separated if those derivatives are not closely related to the available-for-sale host contract.

Determining whether an embedded derivative is closely related to the host contract requires the nature of the host contract and the nature of the underlying of the derivative to be considered. If the nature of the underlying and the host contract are similar, then they are closely related.

IAS 39.AG30, 33 However, a derivative instrument with similar risk factors to the host contract is not necessarily closely related to the host contract. For example:

- an equity host contract and an embedded equity index-linked derivative are not closely related unless they are both exposed to equity characteristics of the same entity;

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- a debt host contract and a leveraged interest rate derivative are not closely related unless the effect of the leverage feature is immaterial;
- the derivative embedded in an inflation-indexed lease contract is closely related to the lease only if the inflation index relates to the same economic environment as the lease contract; and
- a leverage feature that is not insignificant always causes an embedded derivative feature not to be closely related.

IAS 39.AG27, 39.IGC5

Evaluating whether an embedded derivative is closely related requires identifying the nature of the host contract. If the host contract is a financial instrument, its nature may not be obvious because of the embedded derivative. A debt host is characterised by a fixed or determinable maturity and fixed or determinable payments, while an equity host contract gives the holder a residual interest in the net assets of the entity. For example, consider a five-year 'debt' instrument with a principal of one million will be redeemed on a specified date at an amount equal to the principal plus the change in the fair value of 10,000 shares in a listed entity over the term of the instrument. Even though the redemption amount is linked to a listed entity's share price, the instrument has a stated maturity and the host contract therefore has the nature of a debt instrument.

Embedded derivatives that are not closely related

IAS 39.AG30

Examples of instruments that contain embedded derivatives that are not considered closely related to the host contract include:

- an investment in a note or bond that is (optionally or mandatorily) convertible into shares of the issuer, or another entity (for guidance on how to account for a note that is convertible into shares of the issuer, see 5.6);
- an option to extend the remaining term of a debt instrument at an interest rate that is not the market rate at the time of extension;
- a call, put or prepayment option in a debt instrument that is exercisable at an amount other than the amortised cost of the instrument;
- equity- or commodity-indexed principal or interest payments;
- an instrument that the holder has an option to put back to the issuer for an amount based on an equity or commodity price or index;
- an equity instrument that the issuer has an option to call (though only from the holder of the equity instrument); and
- an embedded credit derivative that allows the holder to transfer the credit risk of an asset to another party.

Embedded derivatives that are closely related

IAS 39.AG33

Examples of embedded derivatives that are considered closely related to the host contract and therefore do not need to be separated include:

- an interest rate derivative that changes the interest payable on a debt instrument, if it could not increase the holder's initial return by more than twice what it would have been without the derivative and does not result in a rate of return that is double or more the market return for an instrument with the same terms as the host contract;
- a fixed rate note with an embedded fixed to floating swap;
- an option to extend the maturity of debt at market rates at the time of the extension;
- a call, put or prepayment option at amortised cost in a debt instrument;
- an embedded cap on an interest rate or the purchase price of an asset, provided that the cap is out of the money (i.e., the cap is at or above the market interest rate or price of the asset) when it is issued and is not leveraged. Similarly, separation is not required for an embedded floor on an interest rate or the purchase price of an asset, provided that the floor is out of the money (i.e., the floor is at or below the market interest rate or price of the asset) when it is issued and is not leveraged;

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- a prepayment option in an interest-only or principal-only strip, as long as the original financial instrument did not contain any embedded derivative and the strip does not contain any terms not originally present in the host contract;
- certain inflation-linked lease payments (see *Inflation-indexed embedded derivatives* below);
- a foreign currency derivative that provides interest or principal payments denominated in a foreign currency;
- a foreign currency derivative that provides finance lease payments in a foreign currency provided that the embedded foreign currency derivative is not leveraged and does not contain an option feature; and
- a natural gas supply contract that is indexed to another energy source, if there is no spot price for natural gas in the environment in which the entity operates.

Foreign currency embedded derivatives

IAS 39.AG33(d) Contracts denominated in a foreign currency give rise to an embedded derivative. This includes operating lease contracts, purchase or sale contracts and construction contracts.

IAS 39.AG33(d) An embedded foreign currency derivative is considered to be closely related if:

- the currency is the functional currency of one of the parties to the contract;
- the currency is routinely used in international commerce for that good or service (e.g., the US dollar for crude oil); or
- the currency is commonly used in business transactions in the economic environment in which the transaction takes place (e.g., the US dollar or euro may be used for business transactions in a hyperinflationary economy).

IAS 39.AG33(d) Other embedded foreign currency derivatives are not considered closely related and should be separated.

IAS 39.IGC9 The only commodity that we are aware of that is routinely denominated in a single currency internationally is oil, i.e., in US dollars.

In our view, if a group entity has a separable foreign currency derivative, the derivative is separable both in its stand-alone financial statements, and in the consolidated financial statements, even if the transaction is denominated in the functional currency of the parent, which may be chosen as the presentation currency of the consolidated financial statements (see 2.7). The consolidated entity does not have a functional currency and as such cannot be viewed as having a definable foreign currency exposure that would remove, on consolidation, the need for separation.

IAS 39.AG33(c) A finance lease contract denominated in a foreign currency contains an embedded derivative. However, because finance lease receivables and liabilities are monetary items, the currency exposures on these instruments already are recognised in the income statement because monetary items denominated in a foreign currency are remeasured at the spot rate at the balance sheet date (see 2.7). Therefore, these embedded derivatives are not required to be separated.

For an embedded derivative to exist, the host contract should represent a contractual commitment. For example, forecast but uncommitted sales in a foreign currency, no matter how likely, would not give rise to an embedded derivative. Similarly, in our view, a lease contract only gives rise to an embedded derivative for the period in which the contract is not cancellable. For example, X leases a coffee machine under an operating lease from Y. X can cancel the lease at any time by giving three months' notice. In our view, at each balance sheet date, X has an embedded derivative only for the three months of committed, non-cancellable lease payments.

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Inflation-indexed embedded derivatives

IAS 39.AG33(f)

Inflation-indexed lease payments are considered to be closely related to the host lease contract provided that there is no leverage feature (e.g., a multiple that would be applied to the inflation rate such that the lease payments would increase by X times inflation) and the index relates to inflation in the entity's economic environment (e.g., the consumer price index of the country in which the leased asset is operated). In our view, if the index is based on inflation rates in a different economic environment, then the embedded derivative is not closely related.

In our view, inflation-indexed embedded derivatives in loans are considered to be closely related to the host debt instrument when the inflation index is one commonly used for this purpose in the economic environment in which the debt is denominated.

Accounting for separable embedded derivatives

IAS 39.46, 55

Separable embedded derivatives are required to be measured at fair value with all changes in fair value recognised in the income statement.

IAS 39.AG28, 39.IGC1, 2

The initial bifurcation of a separable embedded derivative should not result in any gain or loss being recognised. The derivative initially should be measured at its fair value (which usually will be zero for a forward and something other than zero for an option). The remainder of the initial cost or issue proceeds should be allocated to the host contract.

Alternative to separation of an embedded derivative

IAS 39.9

Financial instruments within the scope of IAS 39 that contain an embedded derivative may be designated as instruments measured at fair value through the income statement. This eliminates the need to consider whether the risks of the embedded derivative and the host contract are closely related, and also avoids the measurement issues surrounding separating the embedded derivative.

This area of IFRSs may be subject to future development (see 3.6.19).

More than one embedded derivative

IAS 39.AG29

If a single host contract has multiple embedded derivatives, the embedded derivatives generally are evaluated together in determining whether to separate them. However, if the derivatives have different underlying risk exposures and are independent of each other, then they are evaluated separately. For example, a debt instrument may contain an option to choose the interest rate index on which interest is determined and the currency in which the principal is repaid. These are two distinct embedded derivative features with different underlying risk exposures, that should be evaluated separately.

3.6.16 Hedge accounting

Hedge accounting is permitted only when strict documentation and effectiveness testing requirements are met.

The type of hedge accounting model applied depends on whether the hedged exposure is a fair value exposure, a cash flow exposure, or a currency exposure on a net investment in a foreign entity. The section below first provides guidance on the criteria for hedge accounting, qualifying hedging instruments and hedged items and effectiveness requirements and then describes application issues for each of the hedge accounting models.

Hedge accounting criteria

IAS 39.88

Hedge accounting is permitted only if all of the following conditions are met.

- There is written documentation at the inception of the hedge that identifies:
  - the hedging instrument, the hedged item and the risk being hedged;
  - the risk management objective and strategy for undertaking the hedge; and

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  - how effectiveness will be measured – specifying the approaches to be used for both prospective effectiveness testing and retrospective effectiveness testing.
- The effectiveness of the hedge can be measured reliably. This requires the fair value of the hedging instrument and the fair value (or cash flows) of the hedged item with respect to the risk being hedged to be measurable.
- The hedge is expected to be highly effective.
- The hedge is assessed and determined to be highly effective on an ongoing basis throughout the hedge relationship. A hedge is highly effective if the actual offset of changes in fair value of the hedging instrument and changes in the fair value or expected cash flows of the hedged item offset within the ratio of 80:125.
- For a hedge of a forecast transaction, the transaction is highly probable and creates an exposure that ultimately could affect profit or loss.

In our view, the key challenges are identifying a specific asset or liability, or portfolio of similar assets or liabilities, to designate as the hedged item and demonstrating that the hedge is highly effective.

IAS 39.IGF2.6

Risk exposure is assessed on a transaction basis, and overall risk reduction to the entity as a whole is not a condition for hedge accounting. For example, an entity that has exactly matching asset and liability positions may apply hedge accounting to a derivative that is designated as a hedge of the asset, even though the derivative increases the entity's overall risk exposure.

Highly probable forecast transaction

IAS 39.88(c), 39.IGF2.4, 39.IGF3.7

In our view, for a forecast transaction to be considered highly probable, there should be at least a 90 per cent probability of the transaction occurring. In assessing whether a transaction is highly probable, consideration should be given to:

- the quality of the budgeting processes;
- the extent and frequency of similar transactions in the past;
- whether previous similar expected cash flows actually occurred;
- availability of adequate resources to complete the transaction;
- the impact on operations if the transaction does not occur;
- the possibility of different transactions being used to achieve the same purpose;
- how far into the future the transaction is expected to occur; and
- the quantity of anticipated transactions.

IAS 39.IGF3.7

It normally is possible to meet the criterion if significant similar transactions are expected and hedge accounting is limited to a percentage of these forecast transactions. For example, the hedged item may be designated as FC 80 of anticipated sales of approximately FC 100 in March 2005, since it is highly probable that 80 per cent of the anticipated sales will be made. However, if the hedged item is designated as FC 100 of anticipated sales of FC 100 in March 2005, it is unlikely that the highly probable criterion will be met.

IAS 39.IGF3.7

IAS 39 does not specify a time frame in which the transaction must occur, but the transaction must be expected to occur within a "reasonable, specific and generally narrow range of time". Generally, the sooner the anticipated transaction is expected to occur, the easier it will be to demonstrate that the highly probable criterion is met. In our view, forecast periods for most entities are not expected to exceed one year. However, the appropriate forecast period will depend on the industry and economic environment in which the entity operates. For example, we would expect the forecast periods for manufacturers of ships to be longer than those of retail stores because retailers usually sell smaller items in large quantities and can forecast the timing of sales more easily.

Designating the hedged item

IAS 39.84, 39.AG101

The requirement to have a specifically designated and documented hedged item means a net position may not be hedged. Instead, a portion of the assets or liabilities making up the net hedged

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position is designated as the hedged item. For example, it would not be acceptable to designate as the hedged item a net foreign currency exposure of FC 20 million relating to forecast sales of FC 60 million and forecast labour costs of FC 40 million. However, it would be acceptable to designate the hedged item as the first FC 20 million of forecast sales in March 2005.

IAS 39.IGF3.10 If the hedged item is a series of forecast transactions, then the hedged item must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear that it is the hedged transaction. For this reason, the documentation should specify that the hedged item is an identifiable portion of a series of transactions that will occur in a specified period. It is not acceptable to designate a set percentage of transactions, or the last in a series of transactions as the hedged item, because these cannot be identified specifically. For example, the hedged item may be designated as the first FC 20 million of anticipated FC sales in March 2005, but not FC 20 million of anticipated sales in March 2005. As another example, the hedged item is not permitted to be designated as 20 per cent of anticipated US dollar sales over the 2004 financial year.

IAS 39.IGF3.11 The documentation is not required to specify the exact date on which a hedged forecast transaction will occur but (as explained in more detail under *Highly probable forecast transaction* above) the timing of the transaction should be specified within a reasonably specific and narrow range of dates.

IAS 39.81A Macro-hedging, whereby an entity hedges its net exposures, generally does not qualify for hedge accounting under IFRSs. However, an entity is permitted to designate the *interest rate* exposure of a portfolio of financial assets or financial liabilities as the hedged item in a fair value hedge. The hedged item may be designated in terms of an amount of currency rather than as individual assets or liabilities. Although the portfolio may, for risk management purposes, include both assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with the designated amount. Macro hedging is not permitted for risks other than interest rate risk.

Qualifying hedged risks

IAS 39.86, 39.AG110 The hedged risk must be one that could affect the income statement.

Risk components

IAS 39.81, 39.IGF3.5 A financial asset or liability can be hedged against exposure to any one or more of its individual risks that is measurable, including market prices, interest rates or a component of interest rates, foreign currency rates or credit risk.

Non-financial items

IAS 39.82, 39.AG100 A non-financial item must be hedged with respect to either all of its risks or currency risk only because currency risk is the only risk associated with a non-financial item that is considered to be separately measurable.

In our view, for the same reason, it also is acceptable to hedge a non-financial item with respect to all of its risks *except* currency risk.

IAS 39.AG100 When hedging commodity price risk, the hedging instrument often is for a standard-grade commodity and the grade of the actual commodity that will be purchased or sold is likely to differ from this standard-grade. For example, B hedges an anticipated purchase of cocoa beans using a cocoa bean futures contract to purchase standard-grade cocoa beans. The quality of the cocoa beans that ultimately will be delivered may be higher or lower than the standard-grade. Because of the prohibition on designating a portion of a non-financial asset as the hedged item, effectiveness testing must be based on the actual price of the underlying commodity (based on its actual quality), not just the standard-price component. Therefore, B will need to compare the change in value of the futures contract (based on the price of standard-grade cocoa beans), with the change in price of cocoa beans

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of the grade that actually is delivered (this may be higher or lower than the price for standard-grade beans depending on the quality of the cocoa beans delivered). This will give rise to ineffectiveness (see *Effectiveness requirements* below). However, statistical methods such as regression analysis could be performed to establish a statistical relationship between the hedging instrument (the futures contract based on the price of standard-grade cocoa beans) and the hedged item (the actual cocoa beans purchased). The proven statistical relationship then may be used to establish the optimum hedge ratio to maximise expected effectiveness.

Similarly, for hedges of fuel price risk, entities often wish to hedge only one of the components of jet fuel. However, the hedged risk must be designated as the entire jet fuel price exposure and therefore ineffectiveness is likely to arise.

Inventory price exposures

IAS 39.IGF3.6

Commodity price exposure on inventory qualifies as a hedged risk even if the inventory is measured at cost – the profit or loss impact arises when the inventory is sold. However, as noted above, the hedged item must be the entire change in the fair value of the inventory, not just a component of the value changes.

Currency exposures

Hedge accounting normally is applied when an exposure to a foreign currency is converted to the functional currency of the entity that has the currency exposure. In our view, an entity may designate its exposure to changes in either the spot rate or the forward rate as the hedged risk. When exposure to changes in the forward rate is the hedged risk, the interest component included in the forward rate is considered to be foreign currency risk rather than interest rate risk.

IAS 39.IGF2.18

Hedge accounting is not permitted for hedges that convert one currency exposure to another currency exposure, unless the entity has a corresponding position in the second foreign currency, or that second currency is closely correlated to the entity's functional currency. For example, S has the South African rand as its functional currency. S has issued a Japanese yen denominated bond and has a US dollar receivable; both instruments have the equivalent notional amount and the same maturity. To hedge both the US dollar and the Japanese yen exposures, S enters into a forward contract to convert Japanese yen to US dollars. This relationship between the bond (the hedged item) and the Japanese yen to US dollar forward (the hedging instrument) would qualify for hedge accounting. In our view, the hedge documentation should identify both foreign currency positions in designating the hedged risk and in measuring effectiveness both positions should be considered. However, if S had only issued the bond and did not have a US dollar receivable, then the forward contract would not qualify for hedge accounting because it merely changes one currency exposure for another.

IAS 39.IGF2.19

A foreign currency equity security may be designated as the hedged item only if there is a clear and identifiable exposure to changes in exchange rates. This is the case for a net investment in a foreign entity in the consolidated financial statements (see *Net investment hedges* below). For other equity securities, the foreign currency risk has a clearly identifiable exposure only if the equity security is not traded in the functional currency of the investor and does not pay dividends in the functional currency of the investor. However, a forecast sale or purchase of a foreign currency equity security may qualify for cash flow hedge accounting (see *Cash flow hedges* below).

IAS 39.IGF6.5

The currency risk on foreign currency non-financial items (e.g., property plant and equipment and intangible assets) will affect the income statement only if the owner has a forecast sale that will be denominated in a foreign currency. Therefore, in our view, this risk qualifies to be hedged only in a cash flow hedge (see *Cash flow hedges* below). Hedges of the currency risk on non-financial items normally do not qualify for fair value hedge accounting.

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Transactions in own equity

IAS 39.86, 39.IGF2.7 The risks associated with treasury share transactions, forecast transactions in own equity and distributions to shareholders do not qualify for hedge accounting because these transactions are recognised directly in equity and do not affect the income statement.

General business risks

IAS 39.AG98, 110 To qualify for hedge accounting, the hedged risk must be specific and identifiable. A hedge against general business risks, such as physical damage of an asset or an increase in the price payable in a business combination, does not qualify for hedge accounting.

Qualifying hedging instruments

IAS 39.72, 74,75, 39.AG94 All derivatives (including separable embedded derivatives) can qualify as hedging instruments, with the following limitations:

- written options may be designated as hedges of purchased options only (see *Written options* below);
- a derivative may not be designated as a hedging instrument for only a portion of its remaining period to maturity; and
- derivatives must be designated as hedging instruments in their entirety. It is not permitted to designate only certain components of derivatives. For example, the foreign currency component of a cross-currency swap may not be designated as the hedging instrument without the interest rate component of the swap also being a designated and effective hedging instrument.

IAS 39.74-77, 39.IGF1.12-1.14, 3.9 The following uses of hedging instruments are permitted.

- Designating a derivative as a hedging instrument subsequent to its initial recognition.
- Designating a proportion of the notional amount of a derivative, or a proportion of a monetary item (for hedges of currency risk), as the hedging instrument. For example, an entity may designate 60 per cent of the notional amount of a forward exchange contract, which has a notional amount of 1,000, as the hedging instrument in respect of a foreign-currency denominated loan. Therefore, the hedging instrument will have a value of 600. Gains and losses on the proportion of the monetary item or derivative that is not designated as a hedging instrument are recognised immediately in the income statement.
- Designating two or more derivatives in combination as the hedging instrument, as long as none of the derivatives is a written option (see *Written options* below).
- Designating two or more non-derivatives, or a combination of derivatives and non-derivatives, in the case of a hedge of currency risk only.
- Designating a single derivative (e.g., a cross-currency swap) as a hedge of more than one type of risk, if the risks can be identified clearly, it is possible to measure the effectiveness of each of the risks and it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.
- Rolling over a hedging instrument at its maturity, if the rollover is planned and documented at the inception of the hedge relationship.
- Designating a derivative with an external party that offsets an internal derivative as a hedging instrument (see *Hedging on a group basis* below).
- Applying hedge accounting in the consolidated financial statements to a derivative entered into by a group entity different to the one that has the risk exposure (see guidance on *Hedging on a group basis* below).
- Applying hedge accounting to a derivative, even though that derivative is fully offset by another derivative with equal but opposite terms, as long as the second instrument was not entered into in contemplation of the first or there is a substantive business purpose for entering into both instruments in separate transactions.

IAS 39.72 Non-derivatives may be used as hedging instruments for hedges of foreign currency risk only.

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Written options

IAS 39.AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item and therefore does not qualify as a hedging instrument unless it is designated as an offset of a purchased option.

IAS 39.77, 39.IGF1.3 In our view, a combined hedging instrument that is created in a single transaction with the same counterparty and that is made up of a number of components that are not transferable separately may be designated as a hedging instrument, even if one of the components is a written option (e.g., a zero cost collar created in a single transaction with the same counterparty) as long as the combination of derivative components does not result in a net written option.

IAS 39.77 However, an entity is not permitted to designate as the hedging instrument a combination of derivatives, concluded in separate transactions, that includes a written option or a net written option. For example, a zero cost collar that is created synthetically by entering into a cap in one transaction and a floor in a separate transaction would not qualify as a hedging instrument.

Foreign currency hedges

IAS 39.AG95, 39.IGF1.2 For foreign currency hedges, the hedging instrument may be a loan or receivable, a held-to-maturity instrument, a liability or a cash balance. However, a foreign currency firm commitment or forecast transaction does not qualify as a hedging instrument.

IAS 39.IGF1.1, 1.2 For example, J has Japanese yen as its functional currency and has a fixed interest rate US dollar borrowing. The borrowing may be designated as a hedge of the foreign exchange exposure on an investment in a US dollar debt security or a US dollar sales commitment. However, the US dollar borrowing may not be designated as a hedge of the interest and currency exposure on a fixed rate US dollar debt security or the entire fair value exposure on a US dollar sales commitment. This is because non-derivatives qualify as hedges of currency risk only.

IAS 39.77 A combination of derivatives and monetary items may be used as the hedging instrument in a hedge of foreign currency risk.

As explained above, it is important that the currency of the hedging instrument and the currency of the hedged transaction are the same or that a high degree of correlation between the two currencies can be demonstrated. Therefore, extending the above example, a US dollar borrowing may not be designated as a hedge of a euro sales commitment unless a very strong correlation between the US dollar and the euro can be demonstrated.

In our view, an operating lease cannot be designated as a hedging instrument for a hedge of foreign currency risk. This is because payments due or receivable under an operating lease are not a recognised financial liabilities or assets, which could qualify as a hedging instrument for a hedge of foreign currency risk. However, if the operating lease payments are denominated in a foreign currency, then the foreign exchange exposure of these lease payments could qualify as a hedged item.

Qualifying hedged items

IAS 39.78 The hedged item can be (i) a single recognised asset or liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation; (ii) a group of recognised assets or liabilities, unrecognised firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics; or (iii) in a portfolio hedge of interest rate risk only, a portion of a portfolio of financial assets or financial liabilities that share the risk being hedged.

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IAS 39.79, 39.AG94, 39.IGF2.1

The main exceptions are:

- A held-to-maturity instrument may never be a hedged item in a hedge of interest rate risk or prepayment risk, because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of the investment attributable to changes in interest rates. This is an important factor to consider in classifying an instrument as held-to-maturity (see 3.6.4).
- Derivatives (with the exception of written options that are hedged by purchased options) cannot be the hedged item.

IAS 39.IGF2.17

There are no restrictions on the timing of designation or dedesignation of a hedged item. Therefore, it is possible to designate an item as being hedged after its initial recognition. An item also may be designated as hedged for only a portion of its period to maturity.

IAS 39.81, 39.IGF4.6, 39.AG107A

It is possible to designate only a portion of the cash flows or fair value as a hedged item, for example, 85 per cent of the exposure. This applies also for a hedge of a net investment. However, once a partial designation is made, hedge effectiveness is measured on the basis of the hedged exposure. Considering effectiveness on the basis of changes in the fair value or cash flows associated with the full underlying (or a proportion different to that which is designated as the hedged item) to maximise effectiveness is not permitted.

IAS 39.AG99A

If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, then that designated portion must be less than the total cash flows of the asset or liability. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk. The entity also may choose a hedge ratio other than one to one in order to improve the effectiveness of the hedge. This generally involves identifying whether there is a statistical relationship between the hedging instrument and the hedged item, and if there is such a relationship, using the correlation between the items as the hedge ratio.

IAS 39.81

An entity also is permitted to designate only part of the exposure associated with a financial instrument as the hedged item, for example, the currency risk on interest cash flows, but not the currency risk on the principal amount of a foreign currency borrowing.

Portfolio hedging

IAS 39.78, 83

The hedged item can be a portfolio of assets, liabilities, highly probable forecast transactions or net investments in foreign operations, but only if all the items in the portfolio vary proportionally in response to changes in the hedged risk. Also, in a portfolio hedge of interest rate risk only, the hedged item can be a portion of a portfolio of financial assets or financial liabilities that share the risk being hedged. For this reason, it is important to take care in grouping items into appropriate portfolios or to be specific in designating the risk being hedged.

For example, in our view, a portfolio of interest-bearing receivables may be hedged for benchmark interest rate exposure (i.e., exposure to an interest rate commonly referred to in the market for pricing purposes, e.g., LIBOR) because, although each receivable in the portfolio has a different credit risk exposure, the receivables all carry a similar exposure to benchmark interest rates.

IAS 39.IGF2.20

Conversely, an entity may hold a portfolio of equity securities that replicates a stock index and a put option on an equity price index. The fair value of each individual share in the portfolio does not change proportionally to the overall change in fair value of the equity prices of the group; therefore the transaction does *not* qualify for hedge accounting.

Effectiveness requirements

IAS 39.AG109

If a hedge is not perfect, the gain or loss on the hedging instrument will differ from the gain or loss on the hedged item. The difference is called hedge ineffectiveness.

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IAS 39.88(e), 39.AG105 To qualify for hedge accounting, a hedge must be expected to be (prospectively) and actually have been (retrospectively) highly effective. A hedge is regarded as highly effective only if both of the following conditions are met:

- at the inception of the hedge and in subsequent periods (prospective effectiveness test), the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. We expect 'highly effective' to be interpreted as in the range 80:125, as for the retrospective test; and
- the actual results of the hedge (retrospective effectiveness test) are within the range 80:125.

IAS 39.95(b), 102(b) Even when a hedge relationship meets the effectiveness criteria (i.e., actual effectiveness is in the range of 80:125), the gain or loss on the hedging instrument and the gain or loss on the hedged item often will not fully offset. The actual ineffectiveness must be recognised in the income statement immediately even if it is within the 80:125 range.

Frequency of effectiveness tests

IAS 39.AG106 IFRSs do not specify how often effectiveness must be measured, beyond noting that it must be done at a minimum at each reporting date, including interim reporting dates.

IAS 39.AG113 If a hedge no longer is effective, hedge accounting is discontinued prospectively from the last date that the hedge was proven to be effective (see *Stopping hedge accounting* below). Therefore, the more frequently effectiveness is tested, the sooner the entity will identify the opportunity to rebalance its hedges to minimise the impact of ineffectiveness. This provides an incentive to perform hedge effectiveness testing frequently for hedges that may fail the effectiveness tests.

Methods for measuring effectiveness

IAS 39.88(a), 39.AG107 IFRSs do not prescribe the methods that must be used in measuring effectiveness. The method an entity adopts depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, then the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted.

The method that will be used in measuring hedge effectiveness must be specified in the hedge documentation.

Different approaches may be used to measure prospective effectiveness and retrospective effectiveness for a single hedge relationship.

IAS 39.88(a) Also, the approach that will be used to measure effectiveness is determined on a hedge-by-hedge basis. There is no requirement to adopt a consistent approach for all hedge relationships.

IAS 39.AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it must designate the hedged item as that 85 per cent and must measure ineffectiveness based on the change in that designated exposure only.

IAS 39.IGF4.1 Effectiveness calculations may be done on a pre-tax or post-tax basis. Whichever method is used, the basis of calculating the change in fair value or cash flows of the hedged item and the change in fair value of the hedging instrument should be consistent.

Prospective effectiveness

IAS 39.IGF4.4 Prospective effectiveness may be demonstrated using statistical or offset methods or by comparing the critical terms.

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For hedges of currency risk it generally is not possible to demonstrate that a hedge is expected to be highly effective unless both the hedging instrument and the hedged item have the same currency exposure. If the currency exposures are different, the hedge relationship only would be highly effective if there is a very strong correlation between fluctuations in the two currencies.

IAS 39.AG100

In certain circumstances it may not be possible to obtain a hedging instrument that exactly matches the underlying exposure on the hedged item. For example, maybe the only hedging instrument available is an exchange-traded derivative based on a standard quality and grade of a particular commodity to hedge the purchase of a commodity of which the grade and quality actually delivered will depend on where the commodity comes from, purity of the actual product, harvest yield or even consumer demand. In such circumstances it may be possible, using statistical methods such as regression analysis, to establish a statistical relationship between the hedged item and the hedging instrument. Consequently, it may be possible to establish a hedge ratio of other than one to one in order to maximise expected effectiveness. See also the discussion under *Non-financial items*, above.

Retrospective effectiveness

IAS 39.AG105, 39.IGF5.5

Retrospective effectiveness normally is determined using the offset method. The offset method expresses the degree of offset between changes in the fair value of the hedging instrument and changes in the fair value or cash flows of the hedged item as a percentage. The fair value of a forward contract is its notional amount multiplied by the difference between a market forward rate and the contract rate, discounted to its present value. The fair value of a swap is the present value of the expected future cash flows under the swap in each period. The future variable-rate cash flows are estimated based on market forward interest rates at the balance sheet date. A market-related discount rate is used in the present value calculation.

IAS 39.IGF4.2

Retrospective effectiveness may be measured on a cumulative or period-by-period basis. Normally it is advantageous to measure effectiveness on a cumulative basis. For example, if the hedging instrument is an interest rate swap which resets at different times to the interest rate on the underlying, the hedge is more likely to meet the effectiveness tests if effectiveness is measured on a cumulative basis.

Actual ineffectiveness

IAS 39.96

Regardless of the methods that are used to measure prospective and retrospective effectiveness, the actual ineffectiveness recognised in the income statement must be calculated using the offset method on a cumulative basis to ensure that all ineffectiveness is recognised in the income statement immediately. However, in a cash flow hedge, ineffectiveness is recognised in the income statement only when the cumulative change in fair value of the hedging instrument is greater than the cumulative change in fair value or cash flows on the hedged item.

Matching critical terms

IAS 39.AG108, 39.IGF4.7

If the critical terms of the hedging instrument and the hedged item match, then prospective hedge effectiveness can be assumed, but there is no exemption from the requirement to demonstrate retrospective effectiveness.

Examples of situations when the critical terms match are:

- A hedge of a foreign currency sale commitment with a futures contract to sell the same amount of the same foreign currency on the same date, if the fair value of the future at inception is zero.
- A hedge of benchmark interest rate risk associated with a recognised asset or liability using a swap with the same notional amount as the asset or liability and with the same key terms, if there is no change in the value of the swap due to changes in the counterparty's credit risk.
- A hedge of a forecast commodity sale with a forward contract to purchase the same quantity of the same commodity on the same date, if the fair value of the forward at inception is zero.

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Time value and interest element

IAS 39.74 The time value of an option may be excluded from the effectiveness tests and effectiveness may be tested based on the intrinsic value of the option only. Similarly, the interest element of a forward contract may be excluded and effectiveness may be measured based on the spot component of the forward contract only. This choice is available on a hedge-by-hedge basis, and there is no requirement to have a consistently applied policy. However, an entity is not permitted to exclude the credit risk associated with a derivative from the measurement of hedge effectiveness.

IAS 39.96(c) Changes in the fair value of components of the hedging instrument that are excluded from effectiveness measurement (i.e., the time value or interest component) are recognised immediately in the income statement.

If the hedging instrument is an option, we recommend that effectiveness be measured based on the intrinsic value of the option only. This is because the hedged transaction is unlikely to have an equivalent time value effect and therefore, if the time value component of the option is included, it will give rise to ineffectiveness.

If time value is included in the measurement of hedge effectiveness, then the full fair value of the option or forward contract is used in the effectiveness calculation.

IAS 39.IGF5.5 Whichever method is used to deal with the time value of interest elements of hedged items and hedging instruments the basis of calculating the change in fair value or cash flows of the hedged item and the change in fair value of the hedging instrument should be consistent. For example, if time value will be excluded from the measurement of changes in the fair value of the hedging instrument, then the change in the cash flows or fair value of the hedged item should be measured based on spot rates. However, if the time value component will be included in effectiveness measurement, then the change in fair value or cash flows of the hedged item should be based on forward rates.

Interest rate risk

To maximise effectiveness, when hedging interest rate risk, the hedged risk normally is designated as the benchmark interest rate only and the credit risk spread is excluded from the hedge relationship. This is because credit risk normally will not affect the fair value or cash flows of the hedged item and the hedging instrument in the same way.

IAS 39.IGF2.17 Similarly, if the interest exposure on an interest-bearing instrument is hedged for only a portion of the instrument's remaining period to maturity, then it is easier to meet the effectiveness rules if the hedged risk is documented as being based off the same yield curve as the derivative. For example, D hedges the interest rate risk on a 10-year bond for the first five years using a five-year interest rate swap. Effectiveness could be maximised by designating the swap as a hedge of the fair value of the interest payments on the bond for the first five years, and of the change in the value of the principal amount of the bond due to changes in the yield curve during the first five years. If the hedged risk is simply designated as the change in fair value of the bond, then there will be more ineffectiveness because the value of the bond will be affected by changes in the 10-year yield curve whereas the value of the derivative will be affected by changes in the five-year yield curve.

Fair value hedges

Definition

IAS 39.86(a) A fair value hedge is a hedge of changes in the fair value of a recognised asset or liability, an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment.

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IAS 39.AG102 The following are examples of fair value hedges:

- a hedge of interest rate risk associated with a fixed rate interest-bearing asset or liability (e.g., converting a fixed rate instrument to a floating rate instrument using an interest rate swap); and
- a hedge of a firm commitment to purchase an asset or incur a liability.

IAS 39.87 A hedge of the foreign-currency risk on a firm commitment may be accounted for as either a fair value hedge or a cash flow hedge. We generally recommend accounting for hedges of foreign currency firm commitments as cash flow hedges rather than as fair value hedges. This is because, if fair value hedge accounting is applied, and the hedge is in place before there is a firm commitment, then the hedge would be accounted for as a cash flow hedge (see *Cash flow hedges* below) until there is a firm commitment, from which time it would be accounted for as a fair value hedge.

Accounting

IAS 39.89 The hedging instrument is measured at fair value with changes in fair value recognised in the income statement. The hedged item is remeasured to fair value in respect of the hedged risk (even if it normally is measured at cost, e.g., a fixed rate borrowing). Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the income statement (even if such a change normally would be recognised directly in equity, e.g., for an available-for-sale financial asset).

IAS 39.89A For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, the gain or loss attributable to the hedged item may be presented as a single separate line item within assets or liabilities depending on whether the hedged item comprises an asset or a liability for that particular repricing time period.

IAS 39.93, 94 For a hedge of a firm commitment, fair value hedge accounting results in the change in fair value of the firm commitment being recognised as an asset or a liability in the balance sheet during the period of the hedge relationship. When the hedged transaction is recognised, the amount recognised previously in the balance sheet in respect of the fair value of the commitment is transferred to adjust the initial measurement of the underlying transaction.

IAS 39.90 The adjustment to the carrying amount of the hedged item in a fair value hedge often results in the item being measured neither at cost nor fair value, but a mixture of the two. This is because the adjustment:

- is only made for changes attributable to the risk being hedged, not for all risks;
- only occurs during the period when hedge accounting is applied; and
- is limited to the extent that the item is hedged.

For example, Z has a fixed interest liability measured at amortised cost. Z enters into a pay-floating, receive-fixed interest rate swap to hedge half of its benchmark interest exposure. The swap qualifies for hedge accounting. Half of the liability (i.e., the portion that is hedged) will be remeasured with respect to changes in fair value due to changes in the benchmark interest rates from the beginning of the hedge relationship (i.e., from the time the swap is entered into). The liability will not be remeasured for any changes in its fair value due to changes in the credit spread.

This type of partial fair value adjustment requires the various risk factors affecting the hedged item to be identifiable, separable and measurable#.

If the hedge is over-effective, there is no exception from the requirement to recognise all changes in fair value of the hedging instrument in the income statement immediately. Similarly, the full fair value adjustment must be made in respect of changes in the hedged risk of the hedged item, even if the hedge is under-effective. Therefore, any ineffectiveness automatically will be reported in the income

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statement through the accounting process, unlike a cash flow hedge, for which the adjustment has to be calculated and booked (see below).

Cash flow hedges

Definition

IAS 39.86(b) A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with recognised asset or liability or a highly probable forecast transaction and that could affect profit or loss.

IAS 39.AG103 Examples of cash flow hedges are:

- hedges of floating rate interest-bearing instruments;
- hedges of floating rate interest-bearing instruments using an interest rate cap or collar;
- hedges of the currency exposure on foreign-currency denominated future operating lease payments; and
- hedges of highly probable forecast transactions.

Accounting

IAS 39.95 The hedging instrument is measured at fair value with the effective portion of changes in its fair value recognised directly in a separate component of equity, normally called a hedging reserve (see 3.10). Any ineffectiveness is recognised directly in the income statement. This area of IFRSs may be subject to future developments (see 3.6.19).

If the hedging instrument is a non-derivative (permitted for hedges of foreign currency risk only), then the foreign currency gains and losses on the hedging instrument (loan, cash balance or liability) are recognised directly in equity.

IAS 39.97-100 The gain or loss on the hedging instrument that is recognised directly in equity is transferred to the income statement when the future transaction affects the income statement. The practical implications are described below:

- If the future transaction results in the recognition of a non-financial asset or a non-financial liability, then an entity has a choice. It may either include the cumulative amount in equity in the initial cost or other carrying amount of that asset or liability (basis adjustment), or leave the amount in equity and transfer it to the income statement as the related asset or liability affects the income statement (e.g., when the asset is sold or as it is depreciated). The same will apply for a forecast transaction for a non-financial asset or a non-financial liability that becomes a firm commitment for which fair value hedge accounting is applied. The policy chosen must be applied consistently to all cash flow hedges.
- If the future transaction results in the acquisition of a financial instrument, then the amount deferred in equity remains in equity and is recognised in the income statement in the same period or periods during which the financial instrument affects profit or loss (e.g., as it is amortised or when it is impaired or sold).
- If the hedged transaction is recognised in the income statement, then the cumulative amount in equity is recognised in the income statement at the same time as the underlying transaction.

Net investment hedges

IAS 39.88 All the hedging criteria, including the effectiveness criteria, apply equally for a net investment hedge.

Definition

IAS 39.86(c) A net investment hedge is a hedge of the currency exposure on a net investment in a foreign operation using a derivative or a monetary item.

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The hedged risk is the foreign currency exposure on the carrying amount of the net assets of the foreign operation in the group financial statements. Therefore, in our view, net investment hedge accounting may be applied only in the consolidated financial statements.

IAS 39.AG99

Also, the hedged risk cannot be designated as the fair value of the underlying shares (or the currency exposure on the fair value of the shares) because the consolidation process recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. The same is true of a net investment in an associate, because the equity method recognises the investor's share of the associate's profit or loss. Similarly, in our view, the future profits or cash flows of the foreign operation cannot be designated as the hedged item, since these profits or cash flows will be included in the consolidated financial statements and do not expose the group to additional foreign currency risk.

IAS 39.81

Hedging only a percentage of the underlying net assets of a foreign entity is permitted. Effectiveness would be measured based on the percentage of the net assets hedged. However, if the notional amount of the hedging instrument exceeds the carrying amount of the underlying net assets (e.g., due to losses incurred by the foreign operation which reduce its net assets) gains and losses on the excess portion of the hedging instrument must be recognised in the income statement immediately.

IAS 39.IGF2.14

The hedging instrument need not be held by the entity holding the net investment since effectiveness is assessed on a consolidated group basis for consolidated financial statements.

The hedged currency exposure must be the parent's (or other group entity's) exposure on its net investment based on the difference between the foreign operation's functional currency and the investor's functional currency.

Accounting

IAS 39.102

The hedging instrument is measured at fair value. The effective portion of the gain or loss on the hedging instrument is recognised directly in equity (in the currency translation reserve, see 3.10). Any ineffectiveness is recognised in the income statement immediately.

If the hedging instrument is a derivative, hedge effectiveness generally will be increased if the time value is excluded from the assessment of hedge effectiveness. The change in net assets of the foreign operation always is based on changes in spot rates and therefore the time value will give rise to ineffectiveness. As a result, all changes in time value of the derivative will need to be recognised immediately in the income statement regardless of whether they are included in effectiveness measurement. See *Time value and interest element*, above.

IAS 39.102

When the net investment is sold, the cumulative amount in the translation reserve in equity is transferred to the income statement as an adjustment to the profit or loss on disposal. Therefore, it is necessary for an entity to keep track of the amount recognised directly in equity separately in respect of each foreign operation, in order to identify the amounts to be transferred to the income statement on disposal.

Stopping hedge accounting

IAS 39.91, 101

Hedge accounting must be stopped prospectively if the hedged transaction no longer is highly probable, the hedging instrument expires, is sold, terminated or exercised, the hedged item is sold, settled or otherwise disposed of, or the hedge is no longer highly effective.

At the date that hedge accounting is stopped, it is necessary to determine hedge effectiveness and to report any ineffectiveness in the income statement.

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The hedging instrument and the hedged item subsequently are accounted for according to the normal requirements of IFRSs. This means that any derivatives are accounted for at fair value and all changes in the fair value of the derivatives are recognised in the income statement. The items may be designated in a new hedge relationship if the conditions for hedge accounting are met.

IAS 39.92 At the end of a *fair value hedge* relationship, the accounting treatment applied to the hedged item reverts to normal rules. Any adjustments made to the hedged item will reverse when the item is sold or depreciated. However, if the hedged item is carried at amortised cost, then the adjustment will be amortised to profit or loss by adjusting the effective interest rate of the hedged item on the date that amortisation begins. Amortisation may begin as soon as an adjustment exists (i.e., while the hedging relationship still exists) but should not begin later than the date on which the hedged item ceases to be adjusted for changes in fair value attributable to the hedged risk. If, in the case of a portfolio hedge of interest rate risk, amortising using a recalculated effective interest rate is not practicable, then the adjustment shall be amortised using a straight-line method. The adjustment must be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by the expiry of the relevant repricing time period.

IAS 39.101 The treatment of the cumulative gain or loss previously recognised in equity in respect of a *cash flow hedge* depends on whether the hedged transaction still is expected to occur.

- If the transaction no longer is expected to occur, the amount previously recognised in equity is transferred to the income statement immediately.
- If the hedged transaction still is expected to occur, then the amount deferred in equity remains there until the transaction occurs, at which time the normal accounting for a cash flow hedge applies (see *Cash flow hedges* above).

IAS 39.102 For a *hedge of a net investment* in a foreign operation, the cumulative amount previously reported in equity remains in equity until the investment is sold.

Effect of delays and other changes in the forecast transaction

IAS 39.101 If a hedged forecast transaction no longer is expected to occur within the original time period or a relatively short period thereafter, hedge accounting must be terminated. In our view, if the extension of the time period is relatively short, the hedge still may qualify for hedge accounting if the effectiveness criteria continue to be met.

In our view, if the terms or nature of the underlying transaction change significantly, then the original transaction can no longer be considered to be expected to occur and hedge accounting should be discontinued.

Sometimes cash flows in a specific time period are lower than anticipated (e.g., foreign currency sales in one month are below forecast). The entity may expect that lower cash flows in one period will be offset by higher cash flows in another period. However, the hedged item was designated as the cash flows in a certain time period. In our view, hedge accounting normally should be discontinued prospectively from the date that the entity expects the hedged cash flows to be delayed. Hedge accounting may continue only if the entity can demonstrate that specified cash flows have moved into a period shortly after that originally forecast (e.g., because a specific contract has been renegotiated).

IAS 39.88 If the original hedge relationship still is considered to exist, then the entity should reassess whether it is highly probable that the expected future cash flows will take place and whether the hedge still is expected to be highly effective before continuing to apply hedge accounting.

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Hedging on a group basis

IAS 39.73, 39.IGF1.4

Internal derivatives (e.g., derivatives issued by a central treasury function in a group) eliminate on consolidation and therefore are not eligible for hedge accounting in the consolidated financial statements, even if at a group level the overall net position is hedged externally.

IAS 39.80

Similarly, intra-group balances and transactions eliminate on consolidation and therefore these balances and transactions are not permitted to be designated as hedged items. However, foreign currency exposures on intra-group monetary items give rise to foreign currency exchange gains and losses that do not eliminate in the consolidated financial statements (see 2.7). Therefore, the currency risk on recognised intra-group monetary items qualifies for hedge accounting. This area of IFRSs may be subject to future developments (see 3.6.19).

IAS 39.80

Extending this rationale, in our view intra-group monetary items may be the hedging instruments in a hedge of foreign currency risk. This is because the gains and losses on foreign currency intra-group balances give rise to currency gains or losses in the consolidated financial statements that do not eliminate on consolidation.

IAS 39.73, 39.IGF1.4

A subsidiary may apply hedge accounting to internal derivatives or loans in its separate financial statements. Internal transactions also may be reflected in the segment report in the consolidated financial statements. However, in our view, in the case of subsidiaries this requires the hedge to be documented and tested for effectiveness at the level of the subsidiary. In segment reporting if hedging is done centrally and there are no internal transactions or other means for reasonable allocation to the individual segments, then we believe that it would not be appropriate to reflect a hedge relationship in the segment reporting. See 5.2 for an expanded discussion on hedge accounting and segment reporting.

IAS 39.IGF1.4, 2.14

In the consolidated financial statements, hedge accounting may be applied to an external hedge, even if the group entity that is subject to the risk being hedged is not a direct party to the hedging instrument.

IAS 39.IGF2.16

An entity may use internal derivatives to transfer risk from individual operations within the group to a centralised treasury. The centralised treasury may then enter into derivatives with an external counterparty in order to offset the internal derivatives. Such external derivatives may qualify as hedging instruments in the consolidated financial statements provided that they are legally separate contracts and serve a valid business purpose (e.g., laying off risk exposures on a gross basis). However, in our view, entering into a derivative with a non-substantive counterparty does not validate an internal hedge in the manner indicated above. For example, a SPE established to act as a dedicated counterparty to validate internal hedges may not be regarded as a substantive third party counterparty even if consolidation of the SPE is not required.

IAS 39.IGF2.14

For a foreign currency hedge transacted on a group basis, it is important that the currency of the hedging instrument and the hedged transaction is the same. For example, E has the euro as its functional currency. F, a subsidiary of E, has Swiss francs as its functional currency. F has a foreign currency exposure on a forecast US dollar transaction. If E hedges this exposure through its central treasury by entering into a Swiss franc: US dollar forward contract, then the transaction may qualify for hedge accounting in E's consolidated financial statements. However, if E enters into a euro: US dollar forward contract, the contract does not qualify as a hedging instrument because the currency of the forward contract does not match the underlying exposure that the entity wishes to hedge.

Flexibility in the type of hedge accounting

IAS 39.IGF3.3, 3.4, 3.6

In some cases a hedge can be designated either as a cash flow hedge or as a fair value hedge. The designation must be done at the inception of the hedge. For example, a commodity forward contract may be designated as a fair value hedge of commodity inventory or as a cash flow hedge of the anticipated sale of the inventory. Similarly, a receive-fixed, pay-floating interest rate swap may be designated as a fair value hedge of a fixed interest liability or as a cash flow hedge of a variable

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interest asset. However, the interest rate swap cannot be designated as a cash flow hedge of the fixed interest liability because it converts known (fixed) interest cash outflows, for which there is no exposure to variability, into unknown (variable) interest cash outflows. Similarly, the swap cannot be designated as a fair value hedge of the variable interest asset because a variable interest instrument is not exposed to changes in fair value due to changes in market interest rates.

Although the net income statement effect of a hedging relationship ultimately will be the same, regardless of which type of hedge accounting is applied, the timing of recognition in the balance sheet and the income statement, effectiveness measurement and the nature of the accounting adjustments made will differ. Therefore, when there is a choice, it is important to decide on the model at the inception of the hedge and to designate the hedge accordingly.

If cash flow hedge accounting is applied, then the amounts reported in equity must be tracked to ensure that they are reported in the income statement in the correct period and the ineffective portion must be calculated separately. In addition, it is necessary to demonstrate that forecast transactions are highly probable.

In our experience, for hedges of interest rate risk it generally is easier to meet the hedge criteria and to apply hedge accounting if the cash flow hedge accounting model is used. This is because complex systems are necessary to make partial fair value adjustments to the carrying amount of interest-bearing hedged items and it often is difficult to demonstrate hedge effectiveness, particularly if there is a risk of prepayments.

Situations when hedge accounting is not necessary

IAS 39.IGF1.1

In some cases there is no accounting mismatch and hedge accounting is not necessary. Examples of situations in which hedge accounting is not necessary are:

- hedges of recognised foreign currency monetary items with offsetting derivatives or monetary items – as remeasurements of both items with respect to changes in exchange rates are required to be recognised in the income statement at each balance sheet date;
- hedges of instruments measured at fair value through profit or loss – as both the hedged item and derivative hedging instruments are remeasured to fair value through the income statement at each balance sheet date; and
- hedges of commodity inventories that are measured at fair value – as both the derivative hedging instrument and the commodity inventory are remeasured to fair value through the income statement at each balance sheet date.

Economic hedges versus hedge accounting

Hedge accounting is voluntary and the decision to apply hedge accounting is made on a transaction-by-transaction basis.

If an economic hedge does not qualify for hedge accounting then any derivative used must be measured at fair value and all changes in fair value must be reported in the income statement. Often these changes will not be matched by offsetting gains or losses on the items being hedged, for example, because changes in fair value that do occur are not permitted to be recognised without hedge accounting being applied. In our view, the risk management disclosures should contain appropriate explanation of economic hedges that do not qualify for hedge accounting (see 5.6).

3.6.17 Transitional provisions for amendments

IAS 39.103

IAS 32 and IAS 39 were amended in December 2003 and March 2004. The amended standards are effective for periods beginning on or after 1 January 2005. Early adoption of both standards together is permitted.

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IAS 39.104 The general transition principle for entities already reporting under IFRSs is that the amendments should be applied retrospectively and comparative information should be restated, unless restatement is impractical. Any adjustments required are recognised as an adjustment of opening retained earnings of the earliest period presented.

IAS 39.105-108 Any financial asset or liability may be designated as one measured at fair value through profit or loss or available-for-sale at the beginning of the earliest period presented.

IAS 39.105 Any adjustments to measure at fair value instruments designated as fair value through profit or loss are recognised in opening retained earnings and may not be transferred to the income statement when the instruments are sold. Fair value adjustments on instruments designated as available for sale on the date of adoption of the amendments are recognised in a separate component of equity and are transferred to the income statement when the instruments are sold.

IAS 39.106, 107 The derecognition requirements should be applied prospectively to transactions resulting in derecognition after 1 January 2004. The requirements may be applied retrospectively from a date of an entity's choice if all the information required to apply the revised rules was available at the time of the initial transaction.

Changes to the amount of impairment losses recognised for equity securities classified as available for sale as a result of the "significant or prolonged" test should be accounted for retrospectively. Therefore, opening retained earnings and comparative information should be adjusted.

IAS 39.108 When, as a result of applying cash flow hedge accounting, the basis of an asset or liability was adjusted before the revised IAS 39 is applied and the basis will no longer be adjusted under the revised IAS 39, no retrospective adjustment should be made to reverse previous basis adjustments.

IAS 39.108 Any amount recognised directly in equity in respect of a hedge of a firm commitment should be reclassified as an asset or liability, except for a hedge of a foreign currency firm commitment that will continue to be accounted for as a cash flow hedge.

3.6.18 Revisions to IAS 32 and 39 issued in December 2003 and March 2004

As explained at the beginning of 3.6, this section is based on the revised versions of IAS 32 and IAS 39 published in March 2004. IAS 32 and IAS 39 were revised December 2003 and further amendments were made to IAS 39 in March 2004. The changes that resulted from these revisions and amendments are discussed in a separate KPMG publication *Financial Instruments Accounting* (March 2004). In summary, the key changes were:

- The requirements on derecognition of financial assets were significantly reworded and to some extent revised (although for certain transactions the resulting changes to the accounting are substantial), retaining elements of both risks and rewards and control criteria. IAS 39 should now be simpler to apply under the decision tree approach, except in limited numbers of transactions where a new "continuing involvement" approach is adopted, resulting in partial derecognition.
- A new category of "financial assets measured at fair value through profit or loss" is introduced. An entity may choose to include any financial asset or financial liability in this category on the day the asset or liability is first recognised, or on the date the amended standards are first applied. Subsequent transfers in or out of the new category are prohibited. The option to recognise fair value changes on available-for-sale financial assets in income is consequently removed. This area of IFRSs may be subject to future developments (see 3.6.19).
- Similarly, an entity may choose, on initial recognition or when the standards are first applied, to classify any non-derivative financial asset as available for sale, with fair value changes subsequently being recognised as a component of equity.

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- The requirement to separate certain embedded foreign currency derivatives has been relaxed in certain cases, where the currency in which the sale is denominated is not the functional currency of either of the parties to the contract.
- New guidance is provided on the application of the impairment requirements, emphasising that the standards follow an incurred loss model. Impairment losses recognised on equity instruments classified as available for sale are prohibited from being reversed through profit or loss. Any subsequent increase in fair value is instead recognised in equity.
- Further guidance is also provided on how to calculate amortised cost using the effective yield method and on fair value measurement techniques.
- Additional restrictions are placed on the use of hedge accounting in some circumstances, particularly on the use of internal transactions in hedging relationships. Some hedging relationships involving firm commitments that were previously accounted for as cash flow hedges will be accounted for as fair value hedges. The cash flow hedge accounting model has in some cases prohibited basis adjustments and in others made them optional.
- The amended requirements of IAS 39 enable an entity to improve the effectiveness of a hedging relationship by adjusting the amount of the hedging instrument in relation to the hedged item (i.e., applying a hedge ratio of other than one). This is particularly useful when designating non-financial items as hedged items, since it may not always be possible to obtain a hedging instrument with terms that match the hedged item.
- The amendments relax the requirement, in respect of the prospective hedge effectiveness test, that changes in the fair value or cash flows of the hedging instrument should "almost fully offset" changes in the fair value or cash flows of the hedged item. An entity is now required to prove that, at the inception of the hedge and in subsequent periods the hedge is expected to be "highly effective" in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. We expect that this will be interpreted as within the range of 80:125 per cent as with the retrospective hedge effectiveness test.
- IAS 39 now permits fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk. An entity may designate as the hedged item a portion of a portfolio of financial assets or financial liabilities that share exposure to interest rate risk, expressed in terms of an amount of currency, rather than as individual assets or liabilities.
- The requirements on the classification of issued instruments such as preference shares and convertible bonds between liabilities and equity are amended slightly and new requirements are provided on how to account for derivatives on an entity's own equity.
- New disclosures are added, in particular on the sensitivity of fair value estimates to key inputs to a valuation model.

3.6.19 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In March 2004, the IASB issued *The Fair Value Option*, an exposure draft of proposed amendments to IAS 39, which would restrict the use of the fair value option. Under this exposure draft, designation of an instrument at fair value through profit or loss would be permitted only for:

- instruments that contain an embedded derivative, whether or not it is separable;
- a financial liability whose cash flows are linked contractually to the performance of assets that are measured at fair value;
- financial instruments whose fair value changes are substantially offset by other financial instruments;
- financial assets other than loans and receivables; and
- instruments that are permitted or required to be measured at fair value through profit or loss by another IFRS.

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The IASB issued exposure drafts in July 2004 containing the following further proposed amendments to IAS 39:

- requirements for accounting for financial guarantees and credit insurance;
- clarification that, in group financial statements, an entity can designate as the hedged item a highly probable forecast *external* transaction that is denominated in the functional currency of the group entity that enters into the transaction, provided that the transaction gives rise to an exposure that impacts consolidated profit or loss; and
- new transition rules for initial measurement of financial instruments when previously the initial measurement resulted in an immediate profit being recognised.

In addition, the IASB has announced that it plans to provide guidance on presentation of cash flow hedges in the statement of changes in equity. Proposed guidance is expected to be issued during 2004.

IFRIC currently is discussing the application of IAS 39 in accounting for reimbursements receivable from decommissioning and environmental rehabilitation funds (see 3.11).

Also, the IASB has announced that it intends to explore a new hedge accounting model for hedging interest rate margin. The timing of this project is not yet clear.

The IASB's ongoing work includes a project to develop a standard to replace IAS 32 and IAS 39. This project will reconsider a full fair value measurement approach, similar to that proposed by the Joint Working Group (JWG) on financial instruments in its paper *Financial Instruments and Similar Items* published in December 2000. However, the full fair value measurement proposals raised significant controversy and, although the timing of a new standard to replace IAS 39 is uncertain, the IASB has indicated that significant work is necessary before it decides whether to propose a full fair value approach. Therefore, it is unlikely that IAS 39 will be replaced by a new standard in the short term.

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3.7 Inventories

(IAS 2, SIC–1)

Overview

- **Inventories are measured at the lower of cost and net realisable value.**
- **Cost includes all direct expenditure to get inventory ready for sale, including attributable overheads.**
- **The cost of inventory is recognised as an expense when the inventory is sold.**
- **The amount to recognise as an expense must be determined using the FIFO or weighted average method (benchmark) or LIFO (allowed alternative)#.**
- **Other cost formulas, such as the standard cost or retail method, may be used when the results approximate actual cost.**
- **Inventory must be written down to net realisable value when net realisable value is less than cost.**
- **If the net realisable value of an item that has been written down subsequently increases, the write-down is reversed.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 2 *Inventories*. The revised standard is effective for accounting periods beginning on or after 1 January 2005. Early adoption is encouraged. Where an existing requirement is discussed that will be changed by the revised standard, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, under the revised standard the LIFO method is no longer permitted.

3.7.1 Definition

IAS 2.6 Inventories are assets:

- held for sale in the ordinary course of business (finished goods);
- in the process of production for sale (work-in-progress); or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services (raw materials).

IAS 38.2, 3, 40.5, 9 Inventory may include intangible assets that are being developed for resale, for example, software. Inventory also includes properties that have been purchased, or are being developed, for resale.

Financial assets, such as investments, held for resale are not inventory (see 3.6).

Property plant and equipment held for sale

IAS 2.6 Assets held for resale, but not in the ordinary course of the entity's business, are not considered inventories. For example, an entity that manufactures and sells sports cars may acquire a piece of land (property) with the intention of reselling it. The land is not inventory, despite the entity's intention to resell it, unless the entity sells land in the ordinary course of its business in addition to sports cars.

Similarly, it is not appropriate to reclassify a long-term asset, for example, a building, as inventory when the entity decides to sell it#.

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Forthcoming requirements

IAS 1.57, IFRS 5.3 The revised IAS 1 defines current assets to include those that are held for sale. The reclassification of non-current assets as held for sale is considered further in 5.4A.

Spare parts

IAS 16.8 Spare parts, stand-by and maintenance equipment (e.g., tools, consumable lubricants) are classified as inventory, unless they are expected to be used for more than one period, in which case they are classified as property, plant and equipment (see 3.2). This applies to assets held for use within the entity and to those held to provide maintenance services to others.

For example, F, an aircraft charter company that offers aircraft maintenance services, has spare parts. Some of the spare parts will be used in repairs and maintenance of aircraft on behalf of customers. Others will be used in F's own aircraft. The spare parts to be used in the servicing business are accounted for as inventory. Those that will be used in F's own aircraft are accounted for as equipment (see 3.2). Therefore, F needs to distinguish between spare parts to be used for its own aircraft and those to be used in servicing because the accounting treatment of these items is different. When it is difficult to distinguish those items to be used in servicing aircraft on behalf of customers from those to be used for its own aircraft, an allocation should be made based upon how the business is managed. If it is not possible to allocate these items, then, in our view, all items should be included as inventory.

Reusable packaging or parts

Packaging or parts that are sold to a customer but will be returned to the seller to be reused are not inventory if the items will be used during more than one period.

For example, C produces and distributes bottled drinks. C receives a deposit for the bottles when drinks are sold. C is required to buy back empty bottles, which are used again in future periods. Bottles are used for more than one period and are not bought for the purpose of resale. Therefore, the bottles are not inventory; they are an item of equipment that should be accounted for under IAS 16 (see 3.2).

Samples

When samples that may be distributed free of charge are indistinguishable from (and are interchangeable with) saleable products, they are included in inventory. On distribution, the carrying amount of samples should be recognised as an operating expense. However, when such samples are distinguishable they are not inventory as they are not held for sale. Generally, it would be appropriate to recognise the cost of such samples as a prepaid expense until their distribution. If a producer sells products to a retailer and the retailer then gives samples to customers free of charge, the samples would be treated as inventory of the producer.

Catalogues

Catalogues that are to be distributed free of charge to prospective customers are not inventory or property, plant and equipment (see 3.2). In our view, the cost of such catalogues should be recognised as a prepaid expense until their distribution.

Commodities

IAS 2.3 IAS 2 does not apply to producers' inventories of agricultural and forest products and mineral ores that are measured at net realisable value in accordance with well established practices in certain industries. This exemption applies only to producers of these inventories.

IAS 2.1 (1993) There is no exemption for other entities that process or convert these products or for commodity traders or dealers#.

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Forthcoming requirements

IAS 2.3 The revisions made to IAS 2 changed the scope of the standard to exclude also inventories held by commodity broker-traders who measure their inventories at fair value less costs to sell. All changes in the fair value less costs to sell of such inventories must be recognised in the income statement.

Agricultural produce

IAS 41.3 IAS 2 applies to agricultural produce from the point of harvest (see 3.8 regarding biological assets prior to harvest)#.

Forthcoming requirements

IAS 2.3 The revisions made to IAS 2 in 2003 clarify that the scope of the standard excludes the inventories of producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products that are measured at net realisable value in accordance with well-established industry practices. However, these types of inventories are not exempted from the disclosure requirements of IAS 2.

3.7.2 Recognition and derecognition

Inventory is recognised from the date that the entity has the risks and rewards of ownership of the inventory.

In some cases ownership passes on delivery. In other cases a legal principle establishes when the risks and rewards of ownership transfer. For example, when goods are shipped "free on board" (FOB) this means that the risks and rewards of ownership pass to the buyer on the date the goods are shipped. Therefore, inventory includes items purchased FOB and in transit at the balance sheet date.

The carrying amount of inventories is recognised as an expense when the inventories are sold. Therefore, derecognition depends on the timing of revenue recognition (see 4.2). As such, inventory does not include:

- items sold, even if a normal level of returns is expected;
- items sold on an instalment basis; or
- items shipped to customers FOB on or before the balance sheet date.

Consignment stock

The principles above apply also in respect of consignment stock. Therefore, items owned by an entity that are held on consignment at another entity's premises are included as inventory of the consignor. Items held on consignment on behalf of another entity are not included as inventory of the consignee.

3.7.3 Measurement

IAS 2.9 Inventory is stated at the lower of cost and net realisable value.

IAS 2.3 As an exception to the above general rule, producers' inventories of agricultural and forest products and mineral ores may be stated at net realisable value when this is accepted industry practice. If inventories are measured at net realisable value using this exemption, changes in net realisable value must be recognised in the income statements as they occur.

3.7.4 Cost

IAS 2.10 Cost includes:

- purchase costs;
- production or conversion costs; and
- other costs incurred in bringing inventory to its present location and condition, including attributable non-production overheads.

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Purchase costs

IAS 2.11 Purchase costs include the purchase price, transport and handling costs, taxes that are not recoverable and other costs directly attributable to the purchase.

A purchase price may be attributable to several assets, for example, if an entity purchases all of its inventories from a particular supplier. In our view, the purchase price should be allocated to the individual assets based on their relative fair values.

Sales tax

Sales tax paid, for example, value added tax (VAT) generally is recoverable and therefore is not included in the purchase price. In the case of items on which the sales tax is not recoverable, or for entities that are not entitled to a full refund, the sales tax paid that is not refundable is included as part of the cost of the inventory.

Deferred payment

IAS 16.23, 18.11, 39.43 IAS 2 does not address specifically cases when payment for inventory is deferred. However, other IFRSs require interest to be imputed when payment terms include a financing element. Therefore, in our view, if payment for inventory is deferred beyond normal credit terms, and the creditor does not charge a market interest rate, interest should be imputed if the impact is material#.

IAS 16.23, 18.11, 39.47 In our view, when interest is imputed the cost of the inventory should be based on a cash price equivalent. In practice the cash price equivalent is the price for normal credit terms. If a cash price equivalent is not available the cost should be determined by discounting the future cash flows at an interest rate determined by reference to market rates. The difference between the total cost and the deemed cost should be recognised as interest expense over the period of financing using the effective interest rate method.

Forthcoming requirements

IAS 2.18 The revisions made to IAS 2 confirmed that when the arrangement "effectively contains a financing element", that element is recognised as interest over the period of the financing. The financing element is the difference between the purchase price for normal credit terms and the amount paid.

In our view, the length of normal credit terms will depend on the entity, the industry and the economic environment. Periods of high interest rates or high inflation levels also may affect the length of normal credit terms.

Discounts and rebates on purchases

IAS 2.11 Cash, trade or volume discounts and rebates should be deducted from the cost of purchase.

There is no specific guidance on the timing of recognition of rebates or volume discounts. In our view, if it is probable that the rebate or volume discount will be earned, and the amount can be estimated reliably, the discount or rebate should be recognised as a reduction in the purchase price when the inventory is purchased.

For example, Z is a furniture retailer. Z buys beds from Y at a cost of 100 each. Y has agreed to grant Z a 10 per cent refund on all purchases if Z purchases at least 10,000 beds in a six month period. Based on past experience, it is probable that Z will purchase 10,000 beds from Y. Therefore, in our view, Z should record the beds at the expected cost of 90 per unit, and recognise a receivable for the anticipated rebate.

On the other hand, if it is not probable that the required criteria will be met, or if the amount of the rebate cannot be estimated reliably, the rebate should not be recognised until the receipt is probable and the amount can be estimated reliably.

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If the items have been sold when the discount or rebate is recognised, in our view, the discount should be recognised immediately as an adjustment to current period cost of sales.

Extending the above example, assume it is not probable that Z will purchase the required 10,000 beds. After six months Z reaches the target and receives a rebate of 100,000 (10 x 10,000). At that date 4,000 beds are still on hand. The others have been sold. In our view, Z should reduce the cost of each of the remaining beds by 10. Therefore, 40,000 (10 x 4,000) of the rebate should be allocated to reduce the cost of inventory and the remaining 60,000 should be recognised in the income statement immediately as a reduction of cost of sales.

In our view, incentives for early payment (settlement discounts) should be treated as a reduction in the purchase price. In practice, when such discounts are not taken, the cost of inventory is taken to be the higher amount payable before discount, provided that payment is not deferred beyond normal credit terms (see above). This approach is consistent with the assumption that there is no financing element when payment is within normal credit terms.

Costs of production or conversion

IAS 2.12 Costs of production or conversion include all direct costs such as labour, material and direct overheads, and an allocation of fixed and variable production overheads. These include depreciation and maintenance of factory buildings and equipment; amortisation of intangible assets such as software used in the production process; and the cost of factory management and administration. Labour costs include taxes and pension costs associated with labour that is involved directly in the production process. The costs do not need to be external or incremental.

The following should be recognised as an expense and not allocated to the cost of inventory:

- impairment losses (see 3.9);
- goodwill amortisation;
- abnormal amounts of wasted material, labour or other production costs; and
- general administration costs unrelated to the production of inventory (e.g., costs of operating a finance department).

Allocation of fixed overheads

IAS 2.13 The allocation of fixed production overheads is based on the *normal* capacity of production facilities. Any inefficiencies must be charged to the income statement, classified as other operating expenses.

In determining what constitutes normal capacity, the following factors should be considered:

- the nature of the business, economic factors, the status of product life cycles and the reliability of forecasts;
- the capacity and expected utilisation of production facilities including planned maintenance and shut downs; and
- the expected levels of activity to be achieved on average over a number of periods, adjusting for unusual fluctuations or circumstances.

For example, assume that under normal operating conditions J expects to produce 100,000 coffee machines a year. Budgeted and actual fixed production overheads for 2004 are 800,000. Therefore, the fixed overhead cost per machine based on normal production levels is 8.

During 2004, due to problems with the production machinery and decreased demand, J produced only 80,000 coffee machines. The production overheads must be allocated based on the normal production levels of 100,000 (i.e., 8 per unit). Therefore, of the total production overheads of 800,000 only 640,000 (8 x 80,000) is allocated to inventory. The other 160,000 is recognised as incurred.

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On the other hand, if, during 2004, in response to increased demand for coffee machines, J increased production shifts and produced 130,000 machines, the amount allocated to the inventory is limited to the actual expenditure. Therefore, if the total production overheads remain constant at 800,000, a cost of 6.15 (800,000/130,000) is allocated to each machine.

If actual production differs substantially from the normal capacity over a period of time consideration should be given to revising the normal capacity.

Issues may arise when entities have a planned plant shut down. For example, F is involved in freezing and canning fresh fruit. Production takes place during the first six months of the financial year when the fresh fruit is picked. During the second six months of the financial year the production plant is closed and maintenance is performed. No inventory is on-hand during the shut down period. The maintenance costs do not create a fixed asset component (see 3.2). In determining the normal capacity over which production costs will be allocated, F should take into account the annual scheduled plant shut down.

However, in our view, the maintenance cost in the second half of the year cannot be allocated to the production in the first six months because:

- a provision cannot be recognised during the first half of the year for the maintenance costs to be incurred in the second half of the financial year (see 3.11); and
- the maintenance incurred in the second half of the year is a cost of producing the inventory in the following financial year, as it is not necessary to prepare the fruit produced in the first six months for sale.

In our view, the maintenance costs cannot be capitalised and allocated to the following period's production. If F attributes the maintenance cost to the following period's production this will result in the maintenance expenditure being recognised as an asset in the balance sheet. In our view, the maintenance costs do not give rise to an asset as defined in the Framework and therefore they should be expensed as incurred.

Interruptions

IAS 23.24

Interruptions in production may occur during which costs still may be incurred. For example, an entity may continue paying rent on a factory during an unplanned plant shut down or labour strike. IAS 2 does not deal specifically with such circumstances, but in our view, guidance should be drawn from IAS 23 and the capitalisation of borrowing costs (see 4.6), as this standard deals specifically with a similar issue.

Accordingly we believe that costs incurred during an interruption should be capitalised only if:

- the interruption is planned, is temporary and is a necessary part of getting the inventory ready for sale (e.g., the inventory requires time to mature); or
- the costs are directly related to getting the inventory into a saleable condition even though production has been suspended, for example, purchases of additional raw materials during the shut down period.

Therefore, in our view, costs for rent during a strike would not be recognised as part of inventory, but rent costs during scheduled maintenance shut downs may be.

Other costs

IAS 2.15, 38.97

Any other costs that are directly related to bringing inventories to the point of sale and getting them ready for sale also should be allocated. These may include non-production overheads or the costs of designing products for specific customers, including for example, amortisation of development costs relating to a specific product or process.

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Selling and advertising costs should not be included in the cost of inventory.

Distribution, packaging and transport costs

Distribution costs and costs of transporting goods to *customers* are recognised as an expense as incurred. They are not allocated to inventory. However, transport and distribution costs that are necessary to get the inventory in a present location or condition for sale form part of the cost of inventory. The following are examples of costs that should be allocated to inventory:

- the cost of transporting goods from the *supplier*;
- transport or distribution costs that are incurred at an intermediate stage in the production process; and
- transport or distribution costs to get the inventory from a storage location (e.g., warehouse) to the point of sale.

Similarly, packaging costs incurred to prepare inventory for sale are part of the cost of inventory.

Storage or holding costs

Storage and holding costs generally should be expensed as incurred unless:

- storage is necessary before a further stage in the production process;
- the inventory is produced as a discrete project, for example, custom-built furnishings, and the storage cost will be charged to the customer; or
- the inventory requires a maturation process in order to bring it into a saleable condition, for example, whisky, wine or cheese.

Joint products and by-products

A production process may result in more than one output being produced. For example, in the winemaking process grappa is produced from the liquid distilled from the fermented residue of grapes after they have been pressed.

IAS 2.14 If the cost relating to the individual products cannot be identified, the total production costs are allocated between the products on a rational and consistent basis. One possible method is to allocate the total production costs based on relative selling prices. If this method is used it is reasonable to assume the same profit margin for each product unless there is a more accurate method of making the allocation.

IAS 2.14 If a production process results in products that are incidental to the primary product, the cost allocated to these by-products may be based on their net realisable value.

Interest

IAS 2.17 Interest may be capitalised as part of the cost of inventories in some limited cases (see 4.6).

Agricultural produce

IAS 2.20 The fair value of agricultural produce at the date of harvest, less point-of-sale costs, is the deemed cost of the produce for the purpose of applying IAS 2 (see 3.8).

Cost formulas

IAS 2.23 When items of inventory are not interchangeable, cost is determined on an individual item basis. This is appropriate for unique items such as custom-built furnishings, property developments, antiques and works of art.

IAS 2.25 When a cost formula is used because there are many interchangeable items the benchmark treatment is FIFO or weighted average cost.

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IAS 2.23 (1993)

LIFO is the allowed alternative treatment#.

Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received.

The example below illustrates the application of each of the methods.

A uses a periodic inventory system. The following information pertains to December 2004:

	Units	*Unit cost*	*Total cost*
Inventory at 1 December	200	10	2,000
Purchases	50	11	550
Purchases	400	12	4,800
Purchases	350	14	4,900
	1,000		12,250

At 31 December 2004 there are 400 units in stock.

FIFO method

Inventory at 31 December 2004	350 units @ 14	4,900
	50 units @ 12	600
		5,500
Cost of sales December 2004	12,250 - 5,500	6,750

Weighted average cost method

Weighted average unit cost	12,250/1,000	12.25
Inventory at 31 December 2004	400 x 12.25	4,900
Cost of sales December 2004	12,250 - 4,900	7,350

LIFO method#

Inventory at 31 December 2004	200 units @ 10	2,000
	50 units @ 11	550
	150 units @ 12	1,800
		4,350
Cost of sales December 2004	12,250 - 4,350	7,900

Forthcoming requirements

IAS 2

The revised standard prohibits the use of LIFO.

Standard cost method

IAS 2.21

The standard cost method may be used for convenience if the results approximate actual cost. Under a standard costing system the cost of a product is determined using pre-determined rates for the material, labour and overhead expenses based on manufacturing specifications.

To be acceptable as a basis for measuring cost, standard costs must take into account normal levels of materials and supplies, labour efficiency and capacity utilisation, or must be adjusted for variances. Standard costs must be reviewed regularly (at least at each balance sheet date) and adjusted to take into account changes in circumstances.

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When standard costs are not updated to approximate actual costs, it is necessary to analyse the variance accounts and to apportion part of the balance to inventory. If in the above example the standard unit cost was 10, the closing standard cost of inventory of 4,000 (400 x 10) would be increased by 1,500. This adjustment would result in a closing inventory balance of 5,500, the same value obtained under the FIFO method. The adjustment of 1,500 is computed by allocating the purchase price variance applicable to the 400 units of inventory calculated as 350 x (14 - 10) + 50 x (12 - 10).

Retail method

IAS 2.22 The retail method may be used if the result approximates actual cost. This assessment should be reviewed regularly, and at least at each balance sheet date. Under the retail method, inventory is recorded based on its selling price. The cost of the inventory is derived from the selling price by deducting the profit margin. Adjustments must be made when inventory has been marked down to below its original selling price. An average percentage for each retail department may be used if the margins on all the products are similar.

The following example illustrates the retail method:

	Cost	*Retail price*
Opening inventory	6,250	8,000
Purchases	19,500	34,000
Inventory on hand		19,500
Sales for the period		22,500

Using the retail method, closing inventory and cost of sales are calculated as follows:

Cost	6,250 + 19,500	25,750
Retail price	8,000 + 34,000	42,000
Cost percentage of retail price	25,750/42,000	61%
Closing inventory	19,500 x 61%	11,895
Cost of sales	6,250 + 19,500 - 11,895	13,855

The example does not consider the impact of mark-ups or mark-downs on the selling price. The impacts of mark-ups or mark-downs adds to the complexity of the calculation under the retail method and therefore have been excluded to keep the example simple for illustrative purposes.

Base stock method

The base stock method often is used in the hospitality industry, for example, by hotels and restaurants in accounting for linen or silver and glassware. Under the base stock method the cost of initial purchases of equipment to be used in operations is recognised as inventory and carried unamortised as "base stock". The cost of replacement items is expensed when they are acquired.

IFRSs do not specifically allow for the base stock method. In our view, the base stock method may be used for practical reasons if the result obtained approximates the result that would be obtained by applying IFRSs. This assessment should be reviewed regularly, and at least at each balance sheet date.

The treatment that should be applied under IFRSs depends on whether the equipment will be used for more than one period. If the equipment will be used for more than one period then it is property, plant and equipment, and should be recognised at cost and depreciated over its estimated useful life (see 3.2). Otherwise it is inventory. If it is inventory it should be measured at the lower of cost and net realisable value and items should be expensed as they are consumed (replaced).

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Consistency

IAS 2.25 The same type of cost formula need not be used for all inventory. However, the same cost formula must be applied to all inventories having a similar nature and use to the entity.

IAS 2.26 A difference in geographic locations does not justify different cost formulas. But raw materials used by one segment may have a different use from the same raw materials used in another segment and this may justify a different treatment.

For example, J purchases gold and refines it. Some of the refined gold is sold by the wholesale segment. The remainder is used by a segment that manufactures jewellery. The wholesale and jewellery segments may use different cost formulas to account for the refined gold.

A change in cost formulas is justified only if the change results in more meaningful information (see 2.8). However, if an entity purchases inventory items that it did not have in a previous period a new method may be used for the new inventories if they have a different nature and use from other items of inventory.

3.7.5 Net realisable value

IAS 2.6 Net realisable value is the estimated selling price less the estimated costs of completion and sale. The costs of sale include relevant marketing and distribution costs.

IAS 2.34 Any write-down to net realisable value is recognised as an expense. Reversals of previous write downs are recognised in the income statement in the period in which the reversal occurs.

Groups of items

IAS 2.29 Net realisable value write-downs normally are determined on an individual item basis. However, in some cases it may be necessary to evaluate similar products in groups.

For instance in the clothing textile industry it may not be possible to determine selling prices for each textile individually and therefore it may be necessary to perform the net realisable value assessment on all textiles that will be used to produce clothing for a particular season.

However, retailers generally should not determine net realisable value write-downs on the basis of whole department stores as different departments usually have different margins.

Intended use

IAS 2.31 The estimated selling price should take into account the intended use of the items.

For example, if an entity has excess inventories of materials that it will not be able to use in production and therefore that it will sell, the net realisable value of the excess materials should be based on their anticipated sale. These inventories would be valued at the lower of cost and net realisable value.

Operating losses do not result in an automatic write-down of inventory. For example, T is a tractor producer. T also has a servicing division that is operating at a loss. T has some parts that will be used in the servicing business and others that will be used in the production of tractors. The net realisable value of the parts to be used in tractors must be evaluated separately from the net realisable value of the parts to be used in the servicing business. The losses in the servicing division may result in a write-down of the parts that will be used by that division.

Events after the balance sheet date

IAS 2.30 Events after the balance sheet date may provide evidence that the cost of inventory exceeds its net realisable value at the balance sheet date (see 2.9). In these cases the inventory should be written down to its net realisable value.

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Replacement cost

Lower replacement costs do not lead automatically to a net realisable value write-down. However, a write-down would be recognised if the fall in prices means that the finished products will be sold for less than production cost.

Changes in exchange rates

Changes in exchange rates may require a net realisable value write-down.

For example, Z is a book dealer. On 1 December Z orders 20 books at a cost of foreign currency (AC) 110 each. The expected selling price of the books is functional (measurement) currency (BC) 120. The exchange rate AC:BC on 1 December was 0.9. On 20 December when the books are received, the exchange rate is 1.5. Assuming that Z had not hedged the foreign exchange risk on its order, the recorded unit cost of the books would be BC 165, because the inventory is measured based on exchange rates at the purchase date. The anticipated selling price of BC 120 has not changed. Therefore, B should recognise a net realisable value write-down of BC 45 on each book.

3.7.6 Sales contracts

When an entity has a contract to sell inventory for less than the cost of fulfilling the obligations under the contract, the entity has an onerous contract and a provision should be recognised (see 3.11).

Service providers

The inventory of service providers consists of the accumulated costs of providing services to clients. For example, L is a law firm. L's inventory will include unbilled time at the balance sheet date.

The inventories of service providers are accounted for in accordance with the above general principles. Inventory will be recognised only up to the point when revenue in respect of the services is recognised (see 4.2).

Cost

IAS 2.19

The cost of inventory of service providers includes all costs directly related to rendering the services including for example, labour, materials and supplies. The portion of rental premises and other overhead costs that are directly related to the rendering of services also should be included in the cost of inventory. Service providers should not include a profit element or non-production costs in inventory.

Extending the example of the law firm above, assume that lawyers have spent 325 hours on a job. No revenues have been recognised in respect of this job. The anticipated average hourly billing rate on the job is 200. The average hourly cost price (based on the lawyers' salaries and other direct costs) is 80. L's inventory should reflect work-in-progress related to this job of 26,000 (325 x 80).

Net realisable value

IAS 2.29

In determining net realisable value, each service for which a separate selling price will be charged is assessed individually.

3.7.7 Construction contracts

Construction contracts are discussed in 4.2.

3.7.8 Presentation and disclosure

IAS 1.52, 57-59

Inventories are current assets. However, an entity should disclose the amount of inventories that are expected to be recovered after more than one year from the balance sheet date.

Advance payments made in respect of purchases of inventories should not be classified as inventory. Generally, such payments are either a right to receive inventory or cash.

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For agreements other than construction contracts (see 4.2), advance payments received from customers should not be netted against inventories. Advance payments received should be presented in the liability section of the balance sheet, for example, as other liabilities.

IAS 2.36, 37 The carrying amount of each class of inventory must be disclosed separately. Classes of inventories include raw materials, work-in-progress and finished goods. The inventories of a service provider normally are described as work-in-progress.

IAS 2.36, 39 If an entity chooses to allocate expenses by function, the cost of inventories sold during the period must be disclosed. If an entity chooses an allocation of expenses by nature, the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period are disclosed. See 4.1 for additional guidance on income statement presentation.

In our view, write-downs of inventory to net realisable value as well as any reversals of such write-downs should be presented in the same line item in the income statement as the cost of inventories sold.

IAS 2.36(f) The amount of a reversal of a write-down to net realisable value must be disclosed separately. A gain on the sale of inventory previously written down could be viewed as a evidence of an increase in net realisable value, triggering this disclosure requirement in the period of sale. For example, assume that inventory with an original cost of 100 was written down to its net realisable value of 80. In the following period that item is sold for 120. If this gain is viewed as evidence of an increase in net realisable value, a reversal of the write-down of 20 would be disclosed in the period in which the inventory is sold.

Forthcoming requirements

IAS 2.36(d), (e) The revised standard also requires the disclosure of the amount of inventories recognised as an expense during the period and the amount of any write-down of inventories recognised as an expense.

3.7.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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3.8 Biological assets

(IAS 41)

Overview

- **Biological assets are measured at fair value unless it is not possible to measure fair value reliably, in which case they are measured at cost.**
- **All gains and losses from changes in fair value are recognised in the income statement.**

3.8.1 Definition and scope

IAS 41.5 Biological assets are living animals and plants that are capable of biological transformation into either agricultural produce that is accounted for as inventory (see 3.7) or additional biological assets.

Determining whether an asset is a biological asset or inventory sometimes depends on the purpose for which the asset is held. For example, fertilised eggs held for hatching chicks are biological assets, whereas eggs held for sale are inventory.

IAS 41.1 IAS 41 applies to biological assets that are transformed by a process of active management (i.e., agricultural activity). Therefore, it applies, for example, to the following activities: raising livestock; forestry; growing annual or perennial crops; cultivating orchards and plantations; floriculture; and aquaculture (fish farming).

Animals or plants that are not subject to a process of active management are not within the scope of IAS 41. For example, P is a pet shop. P buys baby animals from breeders and then sells them. The pets are accounted for as inventory and are not biological assets within the scope of IAS 41 because P does not actively manage the biological transformation of the animals.

Similarly animals or plants that are used primarily for non-productive purposes, such as recreational parks, are outside the scope of IAS 41. As another example, G owns horses which it trains and uses for racing. The racehorses are owned primarily for non-productive purposes and therefore are not accounted for as biological assets. Instead the horses should be recognised as an asset and depreciated over their estimated useful lives applying the principles in IAS 16 (see 3.2). On the other hand, if G uses racehorses primarily for breeding purposes, then those horses would be within the scope of IAS 41.

3.8.2 Recognition

IAS 41.10 Biological assets are recognised when the asset is controlled by the entity, its cost or fair value can be estimated reliably and future economic benefits are probable.

3.8.3 Measurement

IAS 41.12, 30 Biological assets are measured at fair value less point-of-sale costs. When the fair value of a biological asset cannot be determined reliably at the date of initial recognition, the asset is stated at cost less any accumulated depreciation and impairment losses. If fair value subsequently becomes reliably determinable, the asset then is measured at fair value less point-of-sale costs.

IAS 41.31 Once a biological asset has been measured at fair value less estimated point-of-sale costs, it must continue to be measured on this basis until disposal.

IAS 41.26 Changes in fair value are recognised in the income statement.

Cost measurement

There is no specific guidance on determining cost for biological assets. The general guidance on determining cost in 3.2 and 3.7 applies. The impairment considerations in 3.9 also are relevant.

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Initial measurement

IAS 41.26-29 A gain may arise on initial recognition of a biological asset, such as when a calf is born, or on initial recognition of agricultural produce as a result of harvesting.

Fair value measurement

IAS 41.9 If a market price in an active market is available for a biological asset, the market price should be used as the basis for the fair value of the asset. The fair value of the asset is based on its present location and condition. The costs of transportation of the asset to market must be deducted from the market price in order to determine fair value. This area of IFRSs may be subject to future developments (see 3.8.6).

IAS 41.17 Active markets normally exist for agricultural produce. For example, there are active markets for different grades of green leaf (from which tea is manufactured) and for coffee and cocoa beans.

IAS 41.18 If there is no active market, then an entity should use prices of recent market transactions, market prices for similar assets and sector benchmarks as a basis for measuring fair value. These prices are adjusted to reflect differences in characteristics and / or stages of growth of the assets. These methods would be appropriate when there are recent transactions or markets exist for similar assets. For example, V owns a vineyard in a top wine-growing region in Australia. There is no active market for vineyards in this part of Australia. However, another vineyard was recently sold in the wine-growing region in which V operates. V should use the price of the transaction, adjusted for significant differences in characteristics of the vineyards, to determine a fair value. As the vineyard includes land, the price of the transaction must also be allocated between the land and the vines, as land is not a biological asset.

IAS 41.16 Owners of biological assets may enter into contracts to sell forward the assets or related produce. These contracts may not provide evidence of current fair value, because the fair value must reflect the current market in which a willing buyer and seller would enter into a transaction. However, if the contract is onerous, IAS 37 would apply (see 3.11).

IAS 41.20, 21 In cases when market-based prices or values are not available, the value should be estimated by discounting expected net cash flows at a current market-determined pre-tax rate. The objective is to measure the fair value of the biological asset in its present condition and location. The reference to present location and condition requires that any increase in value from additional biological transformation is ignored. However, the fair value of a biological asset (i.e., the price a buyer is willing to pay) generally would be not only the asset's harvest value but also would include a value for potential future growth. In our view, the potential for future transformation should be included by reflecting the related risks associated with the period until the cash flows occur. This will require a number of factors to be considered, for example:

- risks associated with the asset, such as weather and disease;
- estimated yields; and
- estimated costs in bringing the asset to its intended condition.

These risks should be reflected in either the discount rate or the estimate of expected cash flows.

If a value cannot be estimated reliably, then historical cost would be used instead. For biological assets that have short transformation cycles it will in most cases be possible to estimate reliably a fair value.

In our view, when estimating the future selling price for the purposes of discounting expected net cash flows, current market conditions will generally provide the best evidence on which to base estimates. Alternatively, forward prices may be quoted or annual price increases may have been set if the market is regulated.

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The following example illustrates the application of the fair value measurement hierarchy. F farms salmon. At the balance sheet date the average weight of the salmon is 0.2 kg. The average weight of salmon when they are sold is 4 kg. It is expected that the salmon will be ready for sale three years after the balance sheet date. F expects to sell the salmon for 12 per kg. The per kg value of a 0.2 kg salmon is unlikely to be the same as that of a fully grown salmon. Therefore, it would not be correct to value the salmon at 2.4 each (12 x 0.2). Instead:

- If there is an active market for salmon of 0.2 kg, F should use the market price to value the salmon.
- If an active market does not exist, then F should consider recent market transactions to sell 0.2 kg salmon, market prices for similar fish, or sector benchmarks.
- If market-based prices are not available, F should determine the present value of the expected net cash flows from the salmon. In this case F will need to estimate an appropriate discount rate, the number of salmon expected to reach maturity, the estimated selling price, the time to maturity and the anticipated costs of cultivating the salmon until they are sold. Effectively, the potential growth of the salmon should be included in this fair value measurement. The risk that may impact on the potential growth (e.g., sickness and death of salmon) should be included, either in the discount rate or the estimated cash flows.

IAS 41.24 In some circumstances, cost may be similar to fair value. This may be the case when, for example, there has been little biological transformation since purchase at fair value and selling costs are immaterial.

As mentioned above, biological assets are measured at their fair value based on their present location and condition. Under this approach, costs involved in developing biological assets are expensed as incurred. Essentially, the entity's profit for the period is the difference between the increase in fair value of the biological asset and the costs incurred in that period.

Point-of-sale costs

IAS 41.14 Point-of-sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges and transfer taxes and duties. They do not include transport and other costs to get the assets to market as these costs will already have been deducted from the market value in calculating the fair value of the biological asset in its present location.

Groupings of assets

IAS 41.15 In measuring fair value, assets should be grouped according to their significant attributes. In deciding on the appropriate attributes to use in determining the groupings, an entity should consider the attributes used in the market as a basis for pricing. For example: livestock or fish may be grouped according to age or weight; crops may be grouped according to quality; and trees in a forest may be grouped according to age and type. For assets that are unique, for example, horses held for breeding, each asset may need to be valued individually.

Land

IAS 41.25 Biological assets often are attached physically to land, for example, trees in a forest, and it only may be possible to value the land and the biological assets as a package. However, the accounting treatment for land and biological assets differs. For example, the land may be carried at cost in accordance with IAS 16 (see 3.2) while the trees represent biological assets and should be measured at fair value less estimated point-of-sale costs. Therefore, the value of the package must be allocated. An entity should use information regarding the fair value of the land and the biological assets as a basis to determine the fair value of the biological assets. For example, in some cases it may be appropriate to deduct the fair value of the land from the fair value of the combined assets to arrive at the fair value of biological assets.

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3.8.4 Agricultural produce

IAS 41.3, 13 Agricultural produce, which is the harvested product of an entity's biological assets, is measured at fair value less estimated point-of-sale costs at the point of harvest. Normally market prices are available for agricultural produce. After harvest, agricultural produce is treated as inventory (see 3.7).

Some harvested produce may be subject to additional biological transformation. For example, the processing of grapes into wine or making cheese from milk may include an element of biological transformation. However, these assets are subject to the principles for accounting for inventory, not the requirements for biological assets.

3.8.5 Presentation and disclosure

IAS 41.40 Although changes in fair value of biological assets must be disclosed separately, there are no specific requirements about where in the income statement they should be presented. In our view, the appropriate presentation would depend on the relative significance of agricultural activities. If agricultural activities are part of the core operations of the entity, we believe that changes in the fair value of biological assets should be presented as a separate line item within operating income. Otherwise, they may be presented as part of other operating income and disclosed separately in the notes.

IAS 41.47 When biological assets are measured at fair value, details about the fair value measurement techniques and assumptions must be disclosed.

IAS 41.54, 55 When biological assets are measured at cost because fair value cannot be estimated reliably, detailed disclosures are required.

3.8.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

IFRIC has suggested to the IASB that it considers the following issues:

- how to determine the fair value of a biological asset; and
- how to account for a legal or constructive obligation to re-establish a biological asset after harvest.

This consideration may lead to amendments of IAS 41 to add guidance on the fair value of biological assets.

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3.9 Impairment

(IAS 22, IAS 36, IAS 38, SIC–14)

Overview

- **IAS 36 covers impairment of property, plant and equipment, goodwill, intangible assets and investments in subsidiaries, joint ventures and associates.**
- **Detailed impairment testing generally is required only when there is an indication of impairment.**
- **Annual impairment testing is required for intangible assets not yet available for use and intangible assets and goodwill that are amortised over more than 20 years#.**
- **An impairment loss is recognised if an asset's (CGU's) carrying amount exceeds the greater of its net selling price and value in use, which is based on the net present value of future cash flows#.**
- **Estimates of future cash flows used in the value in use calculation are specific to the entity, and may not be the same as the market's assessment.**
- **The discount rate used in the value in use calculation is a pre-tax rate that reflects the risks specific to the asset.**
- **An impairment loss for a CGU is allocated first by writing down goodwill, then *pro rata* to other assets in the CGU.**
- **Reversals of impairment are recognised, although restricted in respect of goodwill#.**

Forthcoming requirements

In March 2004, the IASB issued a revised version of IAS 36 *Impairment of Assets*. The new standard is applicable to goodwill and intangibles acquired in business combinations with an agreement date on or after 31 March 2004. It applies to all other assets prospectively from the beginning of the first annual period beginning on or after 31 March 2004. Earlier application of the standard is permitted. When an existing requirement is discussed that will be changed by the revised standard, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular the main changes are:

- an additional requirement for annual impairment testing of goodwill and intangible assets that have an indefinite useful life. This impairment test may be performed at any time during an annual reporting period, provided it is performed at the same point each year;
- permission to use the latest calculation of the recoverable amount of goodwill under certain conditions instead of performing a new impairment test;
- additional guidance on making cash flow projections for the purpose of a value in use calculation and on using present value techniques;
- additional requirements in respect of the allocation of goodwill to CGUs. In particular, goodwill must be allocated on the acquisition date to CGUs or groupings of CGUs that are expected to benefit from the synergies of the business combination, and that are no larger than segments;
- new guidance is provided on how to reallocate goodwill when there is a change in reporting structure of an entity; and
- introduction of a prohibition of reversals of impairment losses for goodwill.

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3.9.1 Scope

IAS 36.2, 4 IAS 36 covers the impairment of all non-financial assets except for investment property (see 3.4), inventories (see 3.7), biological assets (see 3.8), deferred tax assets (see 3.12), assets arising from construction contracts (see 4.2), and assets arising from employee benefits (see 4.4). It does not cover financial instruments (see 3.6) but it does apply to investments in subsidiaries, associates and joint ventures.

There is no scope exemption for assets that are not ready for use or sale (e.g., a building under construction).

IAS 36 applies to assets to be disposed of other than by sale, to assets to be disposed of by sale, and to discontinuing operations (see 5.4)#.

Forthcoming requirements

IAS 36.2, IFRS 4, IFRS 5 The revised standard does not apply to non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 (see 5.4A). It also does not apply to deferred acquisition costs and intangible assets arising from an insurer's contractual rights under insurance contracts within the scope of IFRS 4.

3.9.2 Assets to be reviewed

Individual assets

IAS 36.66 Whenever possible the standard should be applied to the individual asset. When this is not possible, assets are tested for impairment in groupings called CGUs.

Cash generating units

IAS 36.66, 67 It may not be possible to assess a single asset for impairment because the asset generates cash flows only in combination with other assets. Therefore, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups thereof (e.g., a plant or division). Such a group is known as a CGU.

IAS 36.69, 36.IE 1 A Identification of CGUs requires judgement and is one of the most difficult areas of impairment accounting. In identifying whether cash inflows from assets or CGUs are largely independent of the cash inflows from other assets or CGUs, various factors, including the manner in which management monitors operations and makes decisions about continuing or disposing of assets and / or operations, should be considered. However, the identification of independent cash flows is the key consideration. For example, in a retail store chain, the fact that stores have different customer bases (and therefore appear to be separate CGUs) is given more emphasis than the fact that the retail store chain is managed at a corporate level (implying the stores form one CGU).

Independent cash inflows

IAS 36.2, 68 The key factor for identifying a CGU is whether it has the ability to generate independent cash inflows. Therefore, when an individual operation generates revenues largely independently from other operations within a group, the operation is a separate CGU. This applies even if the operation is set up as part of an overall strategy within a region, for example, based on management's objective of increasing overall market share or presence in the region.

In our view, if more than half of the cash inflows of an operation are generated independently (i.e., from the operation's own customer base rather than through referred business), the operation is likely to be a separate CGU. In a multinational group that has significant referred sales, we believe that cash inflows are independent if individual units have at least some degree of autonomy to negotiate prices, quality and other features and to terminate contracts independently.

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In our view, if the recoverable amount of an operation is capable of being determined independently (see 3.9.4 to 3.9.6) normally that operation should be treated as a separate CGU. However, if various operations are interdependent, in our view, the interdependent operations together are likely to form a CGU, even if the recoverable amount of an operation is capable of being determined independently. For example, P has been granted a contract by the government to provide services on a country-wide basis. P does not have discretion to choose which areas it will operate in because the contract requires it to supply the entire country with services. Therefore, in our view, all the assets dedicated to the contract form a single CGU, even if cash flows are capable of being determined at a lower level (e.g., for each plant or region).

Vertically integrated businesses

In vertically integrated businesses (i.e., when one unit produces a product and transfers it to another unit within the same group for purposes of further processing or sale) an issue arises as to whether the business as a whole is a CGU, because the individual units do not generate cash flows from outside the group.

IAS 36.70 If an active market exists for the output from a group of assets, that group of assets is a separate CGU, even if the output is sold only to other divisions of the same entity. This is because that group of assets *could* generate independent cash flows.

Goodwill and corporate assets

IAS 36.81, 100 Goodwill and corporate assets do not generate cash inflows independently of other assets or groups of assets. Examples of corporate assets include headquarter buildings, computer equipment and research centres.

IAS 36.80, 86 (1998) Goodwill and corporate assets are allocated to CGUs when the allocation can be done on a reasonable and consistent basis#.

Forthcoming requirements

IAS 36.80 The revised standard requires that goodwill must be allocated to those CGUs or groups of CGUs that are expected to benefit from the synergies of the combination even if no other assets or liabilities of the acquiree are assigned to that CGU (discussed below). The allocation is done at the acquisition date.

Allocation of goodwill and corporate assets#

IAS 36.A64 (1998) IFRSs do not contain specific guidance on how the allocation may be performed on "a reasonable and consistent basis". The appendix to IAS 36 illustrates one possible method of allocation based on the net fair values of the CGUs. The method of allocation illustrated in the appendix assumes that the carrying amounts of the CGUs are a reasonable indication of the proportion of the corporate assets devoted to their respective activities, which may or may not be the case.

Forthcoming requirements

IAS 36.80-86 The revised standard clarifies that goodwill should be allocated to the acquirer's CGUs that are expected to benefit from the synergies of the business combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. The initial allocation must be completed before the end of the first annual reporting period beginning after the acquisition date. Each unit or group of units to which goodwill is allocated should:

- represent the lowest level within the entity for which information about goodwill is available and monitored for internal management purposes; and
- not be larger than a segment based on either the entity's primary or secondary reporting format determined in accordance with IAS 14 (see 5.2).

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Unallocated goodwill or corporate assets#

IAS 36.80, 86

When all, or a portion of, goodwill or corporate assets cannot be allocated reasonably and consistently to one or more CGUs, two levels of impairment tests are carried out. One test is performed at the individual CGU level without the unallocated goodwill and corporate assets (the "bottom-up" test). The second is applied to the minimum collection of CGUs to which all the goodwill and corporate assets can be allocated (the "top-down" test).

If indicators of impairment of goodwill or corporate assets exist, the impairment tests at the individual CGU level will need to be performed even if none of the goodwill or corporate assets can be allocated to the CGUs. This is necessary to determine whether, and if so how much of, an impairment loss exists for the CGUs before considering goodwill and corporate assets.

Forthcoming requirements

IAS 36.100-103

The new standard requires that goodwill be allocated to a CGU or a group of CGUs. Therefore, the requirements for impairment testing of unallocated goodwill have been removed from the standard. The requirements for unallocated corporate assets have not changed significantly.

Minority interests

Forthcoming requirements

IAS 36.91-95

The revised standard provides additional guidance regarding non-wholly owned CGUs (or group of CGUs), in other words when minority interest exists. For impairment testing purposes, the carrying amount of such a unit (or group of units) is adjusted by grossing up the carrying amount of goodwill allocated to the CGU (or group of CGUs) to include the goodwill attributable to the minority interest. This adjusted carrying amount then is compared with the recoverable amount of the unit (or group of units) for impairment testing purposes. However, goodwill is not reported in the financial statements at the grossed-up amount. This area of IFRSs may be subject to future developments (see 3.9.10).

Disposals and reorganisation of reporting structure

Forthcoming requirements

IAS 36.86, 87

Under the revised standard, if an entity disposes of an operation within a CGU (or group of CGUs) to which goodwill has been allocated, the goodwill is included in the carrying amount of the operation when calculating the gain or loss on disposal. The portion of the goodwill allocated is measured based on the relative values of the operation disposed of and the portion of the CGU retained unless the entity can demonstrate another method that is better for reflecting the goodwill associated with the operation disposed of.

The same approach is applied when the entity changes its composition of CGUs. Reallocation is performed using a relative value approach similar to that used when an entity disposes of an operation within a CGU, unless the entity can demonstrate that some other method provides a better allocation of goodwill to the reorganised units.

3.9.3 When to test for impairment

Impairment indicators

IAS 36.9, 12

An entity must assess at each reporting date whether there is an indication that an asset or a CGU is impaired. It is important that the review for impairment indicators be performed at the same level at which the assets will be tested for impairment (see 3.9.2). That is, at the level of the asset or the CGU, rather than at a higher level (e.g., at a segment level).

IAS 36.8 (1998)

Impairment testing generally is required only when there is an indication of a possible impairment. However, specific rules apply for goodwill and other intangible assets (see below)#.

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Forthcoming requirements

IAS 36.10 The revised standard requires impairment testing both:

- for any asset when there is an indication of a possible impairment at the reporting date; and
- annually for the following assets, regardless of whether there is a triggering event:
  - intangible assets with an indefinite useful life and intangible assets not yet available for use (see 3.3); and
  - CGUs to which goodwill acquired in a business combination (see 2.6) has been allocated.

An annual impairment test for the assets above is required *in addition* to any impairment tests performed by the entity as a result of a triggering event occurring at a date within the financial year.

IAS 36.8, 12-15 In determining whether there is an impairment indicator, an entity should consider both internal sources (e.g., adverse changes in performance) and external sources (e.g., adverse changes in the business or regulatory environment). The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated (see 1.2). If previous estimates showed that the asset's recoverable amount was significantly higher than its carrying amount, the entity only needs to reassess the recoverable amount if events have occurred that might have caused that difference to disappear. Also previous analysis might have shown that the recoverable amount of the asset is not sensitive to the indicator, in which case impairment testing may not be required.

IAS 36.12 Two indicators of possible impairment are an increase in market interest rates that will increase the discount rate used to calculate an asset's value in use (see 3.9.6), and the carrying amount of the net assets of an entity exceeding its market capitalisation. An entity must assess whether the magnitude of the change in interest rates or the gap between its net assets and market capitalisation requires calculation of the recoverable amount.

Annual impairment tests

IAS 22.56 (1998), 38.99 (1998) Impairment testing is required annually for goodwill or intangible assets that have useful lives of over 20 years# and for any internally developed intangibles not yet available for use.

Forthcoming requirements

IAS 36.10 Under the revised standard impairment testing is required annually for intangible assets with indefinite useful lives and intangible assets not yet available for use irrespective of whether there is an indication that the related assets may be impaired, as well as whenever there is any indication that they may be impaired. Similarly, CGUs to which goodwill has been allocated should be tested for impairment annually and whenever there is any indication that it may be impaired. The annual impairment test for a CGU (or group of CGUs) to which goodwill has been allocated, and for intangible assets with indefinite useful lives, may be performed at any time within an annual reporting period, provided that the test is performed at the same time every year.

IAS 36.10, 96 If the goodwill relates to a business combination that occurred during the current annual reporting period, the standard requires that the related CGUs be tested for impairment before the end of the current period. The same applies to intangible assets that have to be tested for impairment annually.

IAS 36.24, 99 For the impairment testing of goodwill and intangible assets with indefinite useful lives, an entity may use the most recent calculation of their recoverable amounts (made in a preceding reporting period), provided that certain criteria are met.

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3.9.4 Calculation of recoverable amount

IAS 36.6

The recoverable amount of an asset or a CGU is the higher of its value in use and its net selling price#.

Forthcoming requirements

IAS 36.6

The revised standard replaces the term 'net selling price' with 'fair value less costs to sell'. The meaning is unchanged.

IAS 36.19, 22

It often is easier to determine fair value less costs to sell (net selling price) than value in use. Therefore, if the fair value less costs to sell is available for an asset or a CGU, it normally is easiest to first calculate this amount. If the fair value less costs to sell exceeds the carrying amount, it is not necessary to calculate value in use. If the fair value less costs to sell can be estimated for an individual asset, and the fair value less costs to sell for the estimate can be shown to be close to the asset's value in use, it is not necessary to test the asset on a CGU basis even if the asset does not generate largely independent cash inflows.

3.9.5 Fair value less costs to sell

IAS 36.25

A binding sale agreement will give the best evidence of fair value.

IAS 36.26

If there is no binding sale agreement but there is an active market for the asset, the current market bid price provides the best evidence of fair value. In our view, no adjustments should be made to the market price even when the asset being tested for impairment is a subsidiary or associate and there would be a control premium or liquidity discount on the sale of a large block holding.

IAS 36.27

If there is no binding sale agreement and no active market, the fair value should be determined by considering transactions in similar assets and making appropriate adjustments.

IAS 16.32, 33

In our view, depreciated replacement cost should not be used as a surrogate for fair value because it does not represent the amount for which the asset could be sold.

Costs to sell

IAS 36.28

Costs to sell are *incremental* costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense. Disposal costs do not include costs already recognised as a liability.

3.9.6 Value in use

IAS 36.6

Value in use represents the discounted future net cash flows from the continuing use and ultimate disposal of an asset or CGU#.

Forthcoming requirements

IAS 36.30

The revised standard clarifies that calculation of an asset's value in use should reflect considerations such as:

- the estimated future cash flows that the entity expects the asset to earn;
- possible variations in the amount or timing of those future cash flows;
- the time value of money, which is reflected by using a discount rate that reflects the current market risk-free rate of interest;
- the price for assuming risks for the uncertainty inherent in the asset; and
- other factors, such as illiquidity, that would be reflected in valuing the expected future cash flows from the asset.

IAS 36.32, 36.A

The second, fourth and fifth of these elements can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate.

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Forecast period

IAS 36.33 The value in use calculation should be based on reasonable and supportable assumptions concerning projections of cash flows approved by management (as part of the budget)# and adjusted to the requirements of IFRSs. These cash flow forecasts should cover a maximum of five years unless a longer period can be justified. Thereafter, the cash flow projections are extrapolated into the future over the useful life of the asset or CGU using a steady or declining growth rate that is consistent with that of the product, industry or country, unless there is clear evidence to suggest another basis.

Forthcoming requirements

IAS 36.34 The revised standard requires management to assess the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management also should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes. To do this an entity must consider whether the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make the current projections appropriate.

In our view, the final year of management projections should be used to extrapolate cash flows into the future if the final year represents a steady state in the development of the business. If a steady state has not been reached, we believe that adjustments are necessary to reflect the expected development of the business. Using an average of the projections over the forecast period may be misleading if the expected cash flows are increasing / decreasing over the forecast period. For a CGU that is in the start-up phase, cash flow projections should reflect realistic assumptions regarding revenue growth.

In our view, if a CGU comprises a number of assets with different useful lives, it is necessary to refer to the core assets in the CGU in determining the most relevant period over which to make cash flow projections. For example, if a CGU includes a factory that has a 50-year useful life and machinery with a 10-year useful life, the cash flow forecast should be based on the 50-year useful life of the factory. Depending on the discount rate used (see below), the effect of discounting may mean that cash flows expected in later years have a nominal effect on the value in use calculation#.

Forthcoming requirements

IAS 36.49 The revised standard explicitly requires that if a CGU consists of several assets which are essential to the ongoing business, the impairment test must be determined based on the essential asset with the longest useful life.

Composition of cash flows

The cash flows used in the calculation are those specific to the entity.

IAS 36.39, 41 Cash flows should include cash inflows from continuing use, cash outflows necessary to generate the cash inflows including overheads that can be attributed directly or allocated on a reasonable and consistent basis to the use of the asset, and net cash flows from the ultimate disposal of the asset or CGU.

IAS 36.39, 52 The net cash flow from the disposal of an asset at the end of its useful life is the amount an entity expects to obtain from the disposal in an arm's length transaction after deducting the estimated costs of disposal.

In our view, in the case of an asset or CGU that is in the start-up phase, the cash flow projections should reflect outflows to be incurred in making the asset or CGU fully operational.

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IAS 36.43 To avoid double-counting, estimates of future cash flows should not include cash outflows that will be required to settle obligations that have been recognised as liabilities (e.g., payables, provisions (see 3.11) or liabilities for post-employment benefits (see 4.4)). For example, decommissioning costs should not be included in the calculation of value in use to the extent that a provision for these costs is recognised. Similarly, inflows from assets that generate inflows that largely are independent of the cash inflows from the asset or CGU under review (e.g., receivables) should not be included. However, see 3.9.7 for additional guidance on this issue.

IAS 36.50, 51 Cash flows exclude those from financing activities (because the time value of money is considered by discounting the future cash flows) and tax (because the discount rate is determined on a pre-tax basis, see below).

In some cases an entity may wish to determine cash flows based on (historic or projected) net profits for the asset or CGU. However, net profits generally do not equate to net cash flows. Therefore, in our view, this approach may be acceptable only if the net profit is adjusted to exclude the effects of non-cash items including depreciation and amortisation and accounting revaluations, and to include gross cash flows from the ultimate disposal of the asset or CGU.

Capital expenditures and restructurings

IAS 36.44, 47 Cash flow estimates should reflect the asset in its current condition. Therefore, they should exclude future capital expenditure that will improve or enhance the asset's performance, or restructurings to which the entity is not yet committed and the related benefits (see 3.11).

IAS 36.48 The benefits from capital expenditure should be taken into account in the future net cash flow estimation only once the expenditure is incurred.

IAS 36.49 However, capital expenditure necessary to maintain or sustain the performance of an asset and maintenance expenditure should be taken into account when estimating the future net cash flows. For example, D has a CGU that includes a factory with a useful life of 30 years and some equipment with a useful life of 10 years. The roof of the factory requires replacement after 15 years. If the factory is the essential asset of the CGU that determines the forecast period, the replacement of assets or components of assets with shorter useful lives is considered to be part of the day-to-day servicing of the CGU#.

Forthcoming requirements

IAS 36.49 The revised standard clarifies that when a CGU consists of assets with different useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the cash flows of the CGU.

IAS 36.46, 47 Generally, an entity is committed to a restructuring only when it meets the criteria to recognise a restructuring provision (see 3.11).

Typically, management includes planned cash flows relating to restructurings in their internal budgets and forecasts. For the purposes of impairment testing these budgets generally should be adjusted to exclude these amounts.

IAS 36.42 When impairment testing of an asset that is not ready for use and requires future expenditure to prepare it for use (e.g., a building under construction), these expected cash outflows should be incorporated into the estimated cash flows.

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Relocation costs

Relocation costs are not included in any restructuring provision recognised because they relate to the ongoing activities of the entity (see 3.11). However, in our view, if assets that will be relocated are tested for impairment, the relocation costs should be included in the estimation of future cash outflows.

Transfer pricing

IAS 36.70 (1998) If a CGU sells or purchases goods or services from another operation within the same consolidated group, and the goods or services could be sold in an active market, the market price for the goods or services should be used when estimating the cash flows#.

Forthcoming requirements

IAS 36.70 The revised standard requires that if the cash inflows generated by any asset or CGU are affected by internal transfer pricing, an entity shall use management's best estimate of future prices that could be achieved in arm's-length transactions, rather than internal transfer prices (if different), in estimating the future cash inflows used to determine the asset's or CGU's value in use and the future cash outflows used to determine the value in use of other assets or CGUs affected by the internal transfer pricing. The previous version of IAS 36 restricted this requirement to certain CGUs. This requirement applies to all impairment tests under IAS 36 not just to tests of assets recognised under IFRS 3 (see 2.6).

IAS 24.17 If the two operations are in separate reporting entities, in our view, the actual transaction price should be used when determining the value in use and calculating any impairment loss for the purposes of the separate financial statements of the individual entities. If such transactions take place IFRSs require disclosures in the separate financial statements including nature and amounts (see 5.5).

Foreign currency cash flows

IAS 36.54 When an asset generates cash flows in a foreign currency, the value in use calculation should be performed in the foreign currency. Therefore, cash flows should be estimated in the foreign currency and discounted using a discount rate appropriate for the currency in which the cash flows are generated.

The value in use calculated in the foreign currency should be translated to the functional (measurement) currency of the entity by applying the spot rate at the balance sheet date#.

Forthcoming requirements

IAS 36.54 Under the revised standard, the entity should translate the foreign currency into the functional (measurement) currency of the entity by applying the spot rate at the date of the value in use calculation.

Discount rate

IAS 36.55, 36.A15 The discount rate is a market-related rate that reflects risks specific to the asset. The basis for conclusions to the standard clarifies that a market-related rate is the rate of return that investors would require if they were to choose an investment that would generate cash flows similar in timing, risk and amount to those that the entity expects to derive from the asset. To avoid double-counting, the discount rate must not reflect risks that have been taken into account in estimating the cash flows.

IAS 36.A17, A18 In practice many entities use WACC, the entity's incremental borrowing rate or other market borrowing rates as a starting point in determining an appropriate discount rate. However, as explained below, these rates should not be used without adjustments.

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Pre- or post-tax

IAS 36.55, 36.A15 The cash flows should be determined on a pre-tax basis. Therefore, the discount rate should be a pre-tax rate.

IAS 36.BCZ 85-89, 130 The pre-tax discount rate normally is not the post-tax rate grossed up by the standard tax rate. Differences arise because of the timing of future tax cash flows and discrepancies between the cost of an asset and its tax base. Therefore, it is possible to estimate reliably a pre-tax discount rate using a post-tax rate as a starting point only if information about post-tax cash flows is available. It also may be acceptable to use a post-tax discount rate if cash flows are adjusted to a post-tax basis. Adjusting projections of cash flows to a post-tax basis requires the allocation of tax cash flows to CGUs (although the actual tax return normally is calculated on the basis of legal entities) and the timing of tax cash flows to be determined. Post-tax cash flows cannot be determined simply by applying the tax rate to the pre-tax cash flows. Whichever rate is used (pre- or post-tax), the pre-tax rate needs to be disclosed. An iterative method may be used to calculate the post-tax rate.

Weighted average cost of capital

IAS 36.A17 WACC is a post-tax rate that reflects the capital structure of an entity and entity-specific risks. Therefore, adjustments need to be made to WACC to convert it to a pre-tax rate that is independent of the entity's capital structure (i.e., does not depend on the extent to which the entity is financed by debt as opposed to equity). Appropriate adjustments usually are difficult to determine in practice.

IAS 36.56 The most appropriate WACC to use as a starting point is the WACC of a listed entity that has a single asset (or a portfolio of assets) with similar risks to the asset under review. If such a rate is not available, adjustments need to be made to the WACC of the entity to reflect the risks specific to the asset or CGU that is being tested for impairment.

Inflation

The cash flows and the discount rate applied to them should be determined on a consistent basis. If the cash flows include the effect of general inflation, the discount rate also should include such inflation. Alternatively, if the cash flows exclude the effects of inflation, the discount rate should not include inflation.

Value in use of subsidiaries, joint ventures and associates

IAS 28.33 The value in use of an investment in an associate may be calculated by estimating the cash flows from the investment (i.e., future dividends and expected cash flows from disposal of the shares), or by measuring the cash flows of the underlying operations of the entity as a whole. The value of the net assets of the subsidiary is highly unlikely to be a surrogate for its value in use. In our view, the same approach may be used to determine the value in use of an investment in a subsidiary and a joint venture in the separate financial statements of the parent or venturer.

Assets to be disposed of by sale#

Value in use comprises the cash flows from ultimate disposal *and* continuing use until disposal. Thus, if the asset is still in use, its recoverable amount will not necessarily be its fair value less costs to sell (net selling price) and so any impairment loss may be less than the ultimate disposal loss.

Once the asset is removed from service (because it has no continuing use), its value in use is likely to be the same as its fair value less costs to sell (net selling price) and the expected disposal loss will be recognised as an impairment loss.

Forthcoming requirements

IAS 36.2, IFRS 5 IFRS 5, issued in March 2004, introduces classification and measurement requirements for non-current assets (and disposal groups) held for sale (see 5.4A). That standard requires impairment testing of such assets before classification as held for sale. Generally, non-current assets (and disposal groups) held for sale are measured at the lower of their carrying amount and fair value less costs to sell.

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3.9.7 Recognition and measurement of an impairment loss

IAS 36.6, 59 An impairment loss is recognised to the extent that the carrying amount of an asset or a CGU exceeds its recoverable amount.

IAS 36.60 Impairment losses generally are recognised in the income statement.

Carrying amount of a CGU

IAS 36.6, 75 The carrying amount of a CGU should be determined in a way that is consistent with how the recoverable amount of the CGU is determined. For example, if the cash flow projections include outflows in respect of recognised liabilities, or inflows in respect of assets that generate cash flows independently, the carrying amount that is used to determine the impairment loss should include the related assets and liabilities.

Working capital

In our view, it is acceptable to include cash flows resulting from the realisation of working capital balances in cash flow projections and in the carrying amount of the CGU if the working capital is realised in the short-term and therefore, discounting does not have a material effect.

Alternatively, the cash flow projections may be adjusted to exclude the realisation of working capital balances. In this case, the carrying amount of the CGU also should exclude working capital.

If cash flows from the asset or CGU cannot be generated independently of working capital, then we believe that the first approach should be applied. In our view, if working capital will be increased or decreased during the cash flow forecast period, the actual cash flows resulting from any change in working capital should be reflected in the cash flow forecast.

Revalued assets

IAS 36.5 Assets that are measured at a revalued amount under another standard first are revalued applying the principles in the relevant standard. Any impairment loss is calculated on the basis of the revalued carrying amount. As the recoverable amount to be used in impairment testing is the higher of the asset's fair value less costs to sell (net selling price) and its value in use, any impairment loss to be recognised generally would be limited to its costs to sell.

IAS 36.60 Any impairment loss is charged directly to the revaluation reserve to the extent that it reverses a previous revaluation surplus relating to the same asset.

IAS 36.5(b) When revalued assets are based on depreciated replacement cost (see 3.2), impairment testing of the asset is required.

Foreign entities

IAS 21.49 Impairment losses related to foreign entities are calculated based on the carrying amount of the assets in the consolidated financial statements. When the parent entity's separate financial statements are prepared, the impairment loss should be calculated based on the carrying amounts in the separate financial statements. In either case, no part of the accumulated translation gain or loss that is recognised in equity is transferred to the income statement at the time of an impairment write-down. The translation gain or loss will remain in equity until the foreign entity is disposed of (see 2.7).

Allocation of impairment losses

IAS 36.104-107 Any impairment loss is allocated first by writing down the goodwill that is allocated to the CGU and then *pro rata* amongst the CGU's other assets (including intangibles), except that no asset is written down to below its known recoverable amount. Therefore, an entity should determine the fair value less costs to sell (net selling price) and / or value in use of any of the individual assets or lower level CGU in the CGU being tested, if possible. The impairment loss allocated to an asset should not

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reduce the carrying amount of the asset below the higher of its fair value less costs to sell (net selling price), value in use, and zero.

3.9.8 Reversal of impairment

IAS 36.110 At each reporting date an entity should assess whether there is an indication that a previously recognised impairment loss has reversed. If there is such an indication and the recoverable amount of the impaired asset or CGU subsequently increases, then the impairment loss is reversed.

IAS 36.116 An impairment loss is not reversed when the increase in recoverable amount is caused only by the unwinding of the discount used in calculating the value in use.

IAS 36.109 (1998) For goodwill, an impairment loss is reversed only if the original impairment was caused by a specific, exceptional external event that was not expected to recur and a subsequent external event has reversed its effect#.

Forthcoming requirements

IAS 36.124 The revised standard does not permit an impairment loss recognised for goodwill to be reversed.

IAS 36.117, 123 In all cases the maximum amount of the reversal is the amount necessary to restore the assets of the CGU to their pre-impairment carrying amounts less subsequent depreciation or amortisation that would have been recognised.

IAS 36.119 A reversal of an impairment loss for an asset generally should be recognised in the income statement. A reversal of an impairment loss on a revalued asset should be recognised in the income statement to the extent that it reverses an impairment loss on the same asset that previously was recognised as an expense in the income statement. Any additional increase in the carrying amount of the asset is treated as a revaluation increase.

3.9.9 Presentation

IAS 36.126 IFRSs do not specify in which line item in the income statement an impairment loss should be recognised, but require disclosure of the line items in the income statement in which impairment losses are included.

If an entity classifies expenses based on their function (see 4.1) any loss should be allocated to the appropriate function. In our view, if an impairment loss cannot be allocated to a function, it should be included in other operating expenses as a separate line item, if significant (e.g., impairment of goodwill) with additional information given in a note.

In our view, an impairment loss that is recognised in the interim financial statements which have been published should be presented in the same line item in the annual financial statements, even if the asset subsequently is sold and the gain or loss on disposal is included in a different line item to impairment losses in the annual financial statements.

Forthcoming requirements

IAS 36.134, 135 The disclosure requirements of the revised standard are more extensive than those previously required. The main additional requirements are related to:

- Significant portions of goodwill or intangible assets with indefinite useful lives allocated to a CGU (or a group of CGUs) – For each CGU (or a group of CGUs) to which a significant portion of non-amortised intangibles has been allocated:
  - each key assumption used to determine the recoverable amount of that CGU should be described as well as the entity's approach to determining the values assigned to those assumptions; and

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  - certain information that describes the sensitivity of each key assumption must be disclosed if there is a reasonably possible change that would cause the CGU's (or group of CGUs') carrying amount to exceed its recoverable amount;
- Similar disclosures are required in respect of any non-significant portions of goodwill or intangible assets with indefinite useful lives allocated to a CGU (or a group of CGUs) (see below) if the recoverable amount of any of those units (or group of units) is based on the same key assumptions and the *aggregate* carrying amount of allocated goodwill / intangible assets with indefinite useful lives is significant.
- Non-significant portions of goodwill or intangible assets with indefinite useful lives allocated to multiple CGUs (or groups of CGUs) – An entity must disclose the aggregate carrying amount of goodwill and intangible assets with indefinite useful lives allocated to those units (or groups of units).

3.9.10 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

As part of the IASB's Business Combinations Project (see 2.6 for further information), the Board has decided that the full amount of goodwill arising on a business combination would be recognised, including that portion attributable to minority interests.

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3.10 Equity

(IAS 1, IAS 32, IAS 39)

Overview

- **Instruments are classified as equity or liabilities in accordance with their economic substance.**
- **IFRSs contain very little guidance on recognition and measurement of equity.**
- **Costs of an equity transaction are recognised directly in equity, net of the related tax.**
- **Treasury shares must be reported as a deduction from equity.**
- **Gains and losses on transactions in own equity instruments are reported directly in equity, not in the income statement.**
- **Details of changes in each category of equity must be presented, either as a separate primary financial statement or in the notes to the financial statements.**
- **Dividends and other distributions to the holders of equity instruments (in their capacity as owners) are recognised directly in equity.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements*, IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. The revised standards are applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standards:

- provide guidance on accounting for derivatives based on an entity's own shares;
- clarify that treasury share accounting applies to own shares acquired in connection with equity compensation plans; and
- expand the definition of financial asset, financial liability and equity.

In February 2004, the IASB issued IFRS 2 *Share-based Payment*. This new standard is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. It includes recognition and measurement requirements for equity instruments that are issued in share-based payment transactions. The requirements of IFRS 2 are discussed in 4.5A.

3.10.1 Definition

F.49(c) Equity is defined as a residual interest in the net assets of an entity.

IAS 32.11 An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

IAS 39.2(d), 32.11 Equity instruments include options and warrants on an entity's own equity if they meet certain conditions.

3.10.2 Classification of shares

IAS 32.15 Some instruments issued in the legal form of shares must be classified as liabilities. The classification depends on the economic substance of the instruments. For example, redeemable preference shares are classified as a liability and not as equity.

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Classification as debt or equity involves first considering whether an instrument has the characteristics of a liability. Only an instrument that does not give rise to a contractual obligation to settle in cash or another financial asset is classified as equity#.

Forthcoming requirements

IAS 32.16(b) Under the revised standard, an instrument that may or must be settled in an entity's own shares will be classified as a liability unless:

- If the instrument is not a derivative, the issuer has no contractual obligation to deliver a variable number of its own equity instruments, provided the other criteria have been met.
- If the instrument is a derivative that will be settled only by the issuer exchanging a fixed number of its own equity instruments for a fixed amount of cash or another financial asset, provided the other criteria have been met.

IAS 32.28 Some instruments have characteristics of both debt and equity, for example, convertible bonds. These compound instruments are required to be split between their debt and equity components. While there are no specific requirements regarding the presentation of such items within equity, details of the equity component of outstanding compound instruments should be disclosed#. The equity component of compound instruments may be included in share premium, in a separate category of equity, or in capital reserves. In our view, classification as retained earnings would not be appropriate.

Forthcoming requirements

IAS 32.28 Under the revised standard, a compound debt-and-equity instrument is split into separate debt and equity components and clarifies that such components should be classified separately as financial liabilities or equity instruments.

See 5.6 for additional guidance on and examples of classification issues.

This area of IFRSs may be subject to future developments (see 3.10.9).

3.10.3 Recognition and measurement

IAS 39.2(d) IFRSs do not have any specific measurement rules related to equity, other than in respect of the cost of equity transactions and treasury shares (see below). In part this is because the IFRSs on financial instruments generally do not apply to own equity.

There is no specific guidance on how to treat share options or warrants, bonus issues, share splits, stock dividends and similar transactions#.

Forthcoming requirements

IFRS 2 IFRS 2 includes recognition and measurement requirements for equity instruments that are issued in share-based payment transactions. The requirements of IFRS 2 are discussed in section 4.5A.

As a general principle, the definitions of income and expenses exclude transactions with holders of equity instruments. Therefore, no gains or losses should be reported in the income statement on transactions in own equity. All the effects of transactions with owners should be recognised directly in equity. However, certain derivatives on own equity result in gains and losses recognised in the income statement.

Share splits and bonus issues

IFRSs do not require any adjustment to total equity or to individual components of equity presented in the financial statements in the case of a simple split of shares or a bonus issue. However, the laws of the country of incorporation may require a reallocation of capital within equity.

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There is no guidance in IFRSs on when, or if, a share dividend should be treated as a share split or bonus issue. See 3.10.8 for guidance on the treatment of share dividends.

Share options and warrants

IAS 39.2(d) The requirements for accounting for derivatives do not apply to options and warrants on an entity's own equity, since options and warrants are classified as equity#.

For example, M issues an option to N. The option gives N the right to buy shares in M at a fixed price in the future. M receives a premium of 100 from N. If N exercises the option, M will settle the transaction by issuing its own shares. As such the option is an equity instrument of M and not a derivative. Therefore, M should recognise the premium directly in equity and not in the income statement and should not recognise any subsequent changes in the value of the option. The amount recognised in equity may be included with share premium or other paid-in capital.

Following on from the above example, assume that N does not exercise the option and it lapses. The amount credited to equity in respect of the option premium should remain in equity and should not be transferred to the income statement. If N exercises the option, M should classify the amount received on the exercise of the option as share capital. The option premium may be reclassified within equity. Although reclassification is not required, a consistent policy should be adopted.

Forthcoming requirements

IAS 32.11, 21 The revised standard provides guidance on accounting for derivatives based on an entity's own shares. Derivatives on own equity shares are to be treated as derivatives or as a liability in many cases. Only instruments that would be settled by delivering a fixed number of shares for a fixed amount of cash or other assets and that do not give rise to a liability would be treated as equity.

Prepaid capital contributions

Shareholders may pay for shares before they are issued. An issue then arises as to whether the prepayment should be recognised directly in equity or shown as a liability.

If there is any possibility that the entity may be required to repay the amount received, for example, if the share issue is conditional on uncertain future events, in our view the amount received should be shown as a liability. However, if there is no possibility of the prepayment being refunded, we believe that the amount should be credited to a separate category of equity called, for example, reserve for prepaid shares. The notes to the financial statements should contain disclosure of the prepayment and the terms of the shares to be issued.

Receivables in respect of equity contributions

An entity may be owed an amount in respect of an equity contribution. In this case an issue arises as to when the equity should be recognised.

In our view, the equity and a corresponding receivable is recognised if the receivable meets the definition of a financial asset. This requires the entity to have a contractual right to receive the amount at the balance sheet date. A contractual right is more than an informal agreement or a non-contractual commitment. The other side of the entry would be a credit to equity as discussed above.

We also believe that the receivable for unpaid share subscriptions could be presented as a contra-asset netted against equity.

The reasons for issuing shares before they are fully paid may influence the presentation adopted.

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If a receivable is recognised but payment is not expected in the short-term, the amount should be discounted and recorded in both equity and the receivable balance at the present value of the amount to be received; unwinding of the discount should be accounted for as interest income (see 4.6).

In our view, if the entity has recourse only to the share (and not to other assets) in respect of the receivable, no receivable and no outstanding share should be presented in respect of the transaction.

If the shareholder is not contractually committed to make the contribution at the balance sheet date then no receivable should be recorded in respect of the transaction.

Non-reciprocal capital contributions

Sometimes an entity receives amounts in the form of capital contributions from shareholders without issuing shares in return. This may happen, for example, when an entity requires additional financing or is in financial difficulty. Amounts might be received from all shareholders or only certain shareholders.

IFRSs do not contain any specific guidance on transactions with shareholders. However, applying the definitions of financial liabilities and equity, we believe that:

- If there is any requirement to repay the amount received, a liability should be recognised for the advance.
- If there is no requirement to repay the amount under any circumstances and any repayment is entirely at the discretion of the entity that receives the contribution, the amount received should be accounted for in accordance with its economic substance. In our view, normally the economic substance will be an equity contribution and not income, as generally the shareholder is acting in its capacity as a shareholder in such cases. Our reasoning is that it is highly unlikely that an entity would receive a non-reciprocal capital contribution from an unrelated third party. If it is determined that the shareholder is acting in its capacity as a shareholder the general principle that no gain or loss should be recorded on transactions with shareholders is applied and the amount should be treated as equity.

If the amount is treated as equity it may be classified as additional paid-in capital or perhaps as share premium. In our view, it should not be classified as retained earnings.

The recognition criteria for receivables in respect of equity transactions (see above) should be applied in determining when a non-reciprocal capital contribution is recognised.

3.10.4 Cost of an equity transaction

IAS 32.35 Qualifying costs attributable to an equity transaction (e.g., issuing or buying back own shares) are debited directly to equity, net of any tax effects. Certain equity transactions are excluded from this requirement.

Listing transactions often involve both listing existing shares and issuing new shares. In our view, the costs directly attributable to issuing *new* shares should be recognised directly in equity. However, any costs attributable to listing *existing* shares should be expensed as incurred.

Issuing shares in a private placement is a transaction that results in additional capital being raised and therefore, in our view, costs directly related to issuing equity instruments in a private placement should be recognised directly in equity.

IAS 32.35, 36 The requirement to record in equity all costs attributable to an equity transaction does not apply to costs incurred in relation to a business combination (see 2.6). A listing of existing shares, a secondary offering, share splits and stock dividends do not result in *new* equity instruments being issued, so any costs associated with these transactions should be expensed as incurred.

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IAS 32.38 Qualifying costs that relate to both existing shares and new shares should be allocated on a rational and consistent basis, for example, based on the number of shares. As an example, G will issue 160,000 new shares and list 80,000 existing shares in an IPO. Total costs related to both existing and new shares are 300,000. G allocates the cost between the listing of existing shares and the issue of new shares based on the number of shares. Therefore, the cost allocated to the new shares is 200,000 (300,000 x 160,000/240,000), which will be recognised directly in equity. The cost allocated to listing the existing shares is 100,000 (300,000 x 80,000/240,000), which will be recognised as an expense in the income statement.

Note that only costs that relate to both listing existing shares and issuing new shares should be allocated as explained above. Costs that are directly attributable only to the listing itself, or to the listing of existing shares, should be expensed immediately.

Qualifying costs

IAS 32.37 Only incremental external costs that are attributable directly to issuing or buying back own shares are recognised in equity. Other costs are recognised as an expense in the income statement even if those costs relate to newly issued shares.

For example, assume an entity is issuing new shares and simultaneously listing those shares. The following are examples of costs relating to the transaction that we believe should be recognised in equity, if they are external costs:

- fees for legal and tax advice related to the share issue;
- cost of preparing and printing the prospectus;
- fees incurred in respect of the valuation of the shares;
- fees incurred in respect of the valuation of other assets (e.g., property) if the valuation is required to be disclosed in the prospectus;
- underwriting fees;
- costs incurred in holding press conferences relating to the share issue; and
- costs of handling share applications.

In our view, costs that relate to the listing itself and that are not directly attributable to the new share issue should be expensed. For example, stock exchange registration costs do not relate to the issue of shares but rather to the listing of the issued shares and should therefore be expensed as incurred.

In our view, costs of advertising the share issue should be recognised directly in equity if the advertising relates directly to the share issue and it is not general advertising aimed at enhancing the entity's brand. An example may include external costs related to a road-show where the entity is specifically targeting potential investors. If only a part of the advertising relates to the share issue, an apportionment of the costs may be appropriate.

Costs relating to anticipated equity transactions

Costs relating to equity transactions may be incurred before the equity instrument is issued or bought back. IFRSs are silent on how to treat costs incurred before the equity transaction has been recorded.

In our view, costs that are related directly to an expected equity transaction should be recognised as a prepayment in the balance sheet. The costs should be transferred to equity when the equity transaction is recognised or recognised as an expense if the offering no longer is expected to be completed.

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Cost of issuing compound instruments

IAS 32.36, 38

In the case of compound instruments, transaction costs are allocated to the individual components in a manner consistent with the allocation of the proceeds (see 5.6). The costs related to the liability component should be dealt with in accordance with the requirements for transaction costs associated with financial liabilities (see 5.6), whereas the costs related to the equity component should be reported as a deduction from equity.

Related tax benefits

IAS 32.39, 12.61

The tax effects of any transaction costs that are recognised in equity also should be recognised directly in equity.

If the tax benefits associated with the transaction costs are not probable the tax or deferred tax asset is not recognised (see 3.12 and 4.7). In these cases the gross transaction costs should be deducted from equity. If in a subsequent period the tax benefits related to the transaction costs qualify for recognition, the corresponding credit will be recognised directly in equity.

Presentation in equity

IFRSs do not specify which component of equity the transaction costs recognised in equity should be charged against. There are two alternatives:

- present the transaction costs as a deduction from share capital, share premium or other paid-in capital; or
- recognise the transaction costs as a deduction from retained earnings and present them as a separate item in the statement of recognised gains and losses (see 2.2).

In our view, the first alternative is preferable.

Whichever method is chosen should be applied consistently to all costs of equity transactions. Also, the tax effects of the transaction should be reported in the same component of equity as the underlying costs.

If shares are issued at par value, regulatory issues may prevent the amount from being deducted from share capital. In this case the transaction costs may be presented as a deduction from other share premium, other paid-in capital, retained earnings or shown as a separate reserve. If the transaction costs are presented as a deduction from share capital, we recommend note disclosure of the impact of transaction costs. For example, assume shares are issued at their par value of 10,000. Transaction costs are 1,000. The suggested note disclosure would be as follows:

Share capital (par value)	10,000
Transaction costs	(1,000)
Share capital in the balance sheet	9,000

Example

The example below illustrates the application of the approach explained above. Q issues additional shares for proceeds of 60,000. The total par value of those shares is 6,000. The costs of the transaction are 12,000. It is probable that Q will receive a tax deduction in future periods in respect of the transaction costs. The tax rate is 30 per cent.

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The accounting entries to record the transactions are as follows:

		Debit	Credit
Cash		60,000	
Share capital			6,000
Share premium			54,000
Deferred tax asset	12,000 x 30%	3,600	
Share premium		8,400	
Cash			12,000

A debit balance may arise on a component of equity as a result of recognising transaction costs in that component of equity. In our view, this is acceptable under IFRSs.

3.10.5 Statement of changes in equity

IAS 1.8, 96, 97

A statement of changes in equity must be presented as a primary statement. The statement must include all recognised gains and losses, including those recognised directly in equity (see below) and the cumulative effect of changes in accounting policy and the correction of errors (see 2.8).

The statement may be expanded to comprise a reconciliation of opening and closing equity. When this approach is adopted the statement also must include the amounts of transactions with equity holders acting in their capacity as equity holders (see 3.10.3). Alternatively, such a reconciliation may be presented separately in the notes to the financial statements.

In practice both presentations are used and no single preference has developed. A statement that excludes transactions with owners and therefore does not provide a reconciliation of opening and closing equity can be described as a statement of recognised gains and losses. This area of IFRSs may be subject to future developments (see 3.10.9).

IAS 1.96, 97, 101

The statement of changes in equity comprises the profit for the period; gains and losses that are recognised directly in equity; dividends; and other movements in capital and each reserve.
The following page contains an example statement of changes in equity. Note that comparative information also is required. Also, a sub-total of total gains and losses recognised directly in equity must be presented#.

Forthcoming requirements

IAS 1.96(c)

The revised standard requires that the statement also include a sub-total of all income and expenses for the period, being the total of the profit and loss for the period and any amounts recognised directly in equity. The example statement on the following page illustrates this additional requirement.

Under the revised standard the total amounts of income and expenses for the period attributable to equity holders of the parent and minority interest must be shown separately.

Generally sub-classifications are presented for: share capital; share premium; treasury shares; revaluation reserves; hedging reserves; foreign exchange translation reserves; and retained earnings. Additional sub-classification of capital and reserves may be necessary.

For examples of gains and losses that are recognised directly in equity and a discussion of the issues relating to the presentation of these items (see 2.2).

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	Share capital	*Share premium*	*Treasury shares*	*Equity portion of convertible bonds*	*Translation reserve*	*Revaluation of available-for-sale assets*	*Hedging reserve*	*Other revaluation reserves*	*Other reserves*	*Retained earnings*	*Total*
Balance at 1 January 2004	100	600	(50)	-	25	-	5	-	200	400	1,280
Changes in accounting policies							-			15	15
Restated balance at 1 January 2004	100	600	(50)	-	25	-	5	-	200	415	1,295
Foreign exchange translation differences					(10)						(10)
Revaluation of property, plant and equipment before transfer to investment property								20			20
Net gains on cash flow hedging instruments							22				22
Net gains on available-for-sale financial assets						38					38
Net gains on hedges of net investments in foreign entities					10						10
Net gains on cash flow hedging instruments transferred to income statement							(12)				(12)
Net gains on cash flow hedging instruments transferred to adjust cost of assets							(13)				(13)
Net gains on available-for-sale assets transferred to the income statement on disposal						(5)					(5)
Impairment of available-for-sale assets transferred to the income statement						35					35
Net profit for the period										200	200
Total income and expense for the period	-	-	-	-	-	68	(3)	20	-	200	285
Share options exercised by employees	20	20									40
Issue of share capital	30	200									230
Convertible bonds issued - equity component				15							15
Transaction costs	(5)	(10)		(5)							(20)
Treasury shares sold			25								25
Appropriations to other reserves									100	(100)	-
Dividends to shareholders										(75)	(75)
Balance at 31 December 2004	145	810	(25)	10	25	68	2	20	300	440	1,795

Comparatives are required also (not shown)

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There are no specific requirements in IFRSs on how to present the individual components of equity. Therefore, in our view, net accumulated losses may be offset against another component of equity, for example, additional paid-in capital, if the applicable laws permit this.

F.66, IAS 30.50 Laws in some countries require reserves to be established for specific purposes. For example, banks may be required to set aside amounts for general banking risks or losses on loans. Some entities also establish reserves if national tax laws grant exemptions from, or reductions in, tax liabilities when transfers to such reserves are made. IFRSs neither require nor prohibit the creation of such reserves, which are merely allocations and designations of components of equity. If such reserves are created, in our view they must be classified as a separate component of equity and created by an appropriation from another category of equity, preferably retained earnings. Transfers to these reserves, and their related tax effects, must be recognised through the statement of changes in equity; they may not be recognised through the income statement. These reserves may not be recognised as liabilities in the balance sheet.

Income tax

IAS 12.61 All changes in equity are recorded net of any related current and deferred tax. The amount of current and deferred tax recognised directly in equity must be disclosed separately. There is no requirement to present the tax impact separately in the statement of changes in entity. In practice the tax effects normally are disclosed in the notes to the financial statements (see 3.12 and 4.7).

Some entities present a separate category of equity for current and deferred taxes charged directly to equity. In our view, it is preferable to present the tax effects of equity transactions in the same category of equity as the underlying transaction and we do not recommend creating a separate category of equity for taxes.

Minority interests#

Forthcoming requirements

IAS 1.96, 97, 1.IG, 27.33 The revisions to IAS 27 require minority interest to be presented in the consolidated balance sheet within equity, separately from the parent's shareholders' equity. Therefore, a statement of changes in equity should include an analysis of the amounts attributable to minority interests.

3.10.6 Capital maintenance

IFRSs do not establish requirements about what assets or net assets must be retained and what may be distributed. This is a legal issue that will depend on the regulatory environment in which an entity operates.

IAS 1.76(b) If there is a legal prohibition on the distribution of certain reserves, and an entity wishes to indicate these restrictions in the statement of changes in equity, we recommend transferring the restricted amounts to a separate component of equity, for example, a non-distributable reserve or a capital reserve, if the law permits. Any such transfer would be made through the statement of changes in equity (see 3.10.5). In any case, the restrictions on distribution should be disclosed in the notes to the financial statements.

3.10.7 Treasury shares

Recognition and measurement

IAS 32.33 Generally any amounts paid by an entity to acquire its own shares are debited directly to equity. This applies whether the shares are cancelled immediately or held for resale (i.e., treasury shares). Amounts received on the sale of treasury shares are credited directly to equity. No gains or losses are recognised in the income statement on any transactions in own shares and changes in the value of treasury shares are not recognised.

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SIC 16.3 (1998)

However, it is not clear whether the requirements to present treasury shares and treasury share transactions in equity apply to treasury shares held in connection with an equity compensation plan (see 4.5). In our view, the guidance regarding treasury share transactions, while not establishing recognition and measurement guidance for equity compensation plans, should be applied to treasury shares held in connection with those plans. However, in practice such treasury shares sometimes are presented as an asset#. Assets held in respect of employee benefit plans other than equity compensation plans may include the employer's own shares. If these shares meet the definition of plan assets, they are measured at fair value and included with the other plan assets that are offset against the employee benefit obligation (see 4.4).

Forthcoming requirements

IAS 32.4(f), 33, 34

The revised standard clarifies that own shares held in connection with an equity compensation plan are within the scope of IAS 32 and therefore are required to be presented as treasury shares.

Treasury shares held for trading purposes

IAS 32.A6, 36

Some entities hold their own shares for trading purposes, for example, these shares may be part of a portfolio of investments held for trading purposes.

There are no exemptions for treasury shares held for trading purposes. Therefore, treasury shares (even held for trading purposes) may not be recognised as assets or measured at fair value with gains and losses recognised in the income statement (which is the treatment for other trading investments (see 3.6)).

Treasury shares held for hedging purposes

Treasury shares also may be held for hedging purposes, for example, to hedge an exposure to an index-linked structured note when the index includes the entity's own share price. A hedging intention is not sufficient to override the treasury share accounting requirements, even though this may give rise to an income statement mismatch. In this example, the index derivative feature in the structured notes will be recorded at fair value with all changes in fair value in the income statement (see 3.6). Any own shares held to hedge the index will be accounted for as treasury shares and changes in value of the treasury shares will not be recognised.

In our view, the hedge accounting principles explained in 3.6 are not applicable for treasury shares. Treasury shares cannot be designated as a hedging instrument – the only non-derivatives that qualify as hedging instruments are financial assets or liabilities, and own equity is not a financial asset or liability. Also, treasury shares cannot be designated as the hedged item – the hedged risk must be one that could affect reported income, and gains and losses on treasury shares are never reported in the income statement.

Treasury shares held by subsidiaries

IAS 32.33

In consolidated accounts, treasury share accounting applies to own shares that are held by a consolidated subsidiary.

For example, S is a subsidiary of P. S has a two per cent investment in P. S classifies the investment as available-for-sale. The investment was acquired at a cost of 72,000. The current fair value of the investment is 87,000. P would record the following accounting entry in respect of the treasury shares on consolidation of S:

	Debit	*Credit*
Available-for-sale revaluation reserve	15,000	
Treasury shares (equity)	72,000	
Available-for-sale investments		87,000

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Following on from this example, assume that in the next period S sells its investment in P for 90,000. S would record a profit of 18,000 in the income statement on the sale of the investment. On consolidation, P would record the following elimination entry:

	Debit	Credit
Profit on disposal of investments	18,000	
Equity		18,000

Note that any current or deferred tax on the transactions also should be recognised in equity (see 4.7 and 3.12).

Treasury shares held by associates

IAS 32.33, 1.76

An associate may have an investment in its investor. The carrying amount of the associate under the equity method will include the investor's share of the associate's investment in the investor's own shares.

In our view, the investor is not required to make any adjustment in respect of treasury shares held by an associate. We do not believe the investor should reclassify this portion of the carrying amount of the investment in the associate as a deduction from equity. Similarly, if dividends are declared on these shares, no adjustment should be made to the entity's share of the associate's profit during the year. We believe that the lack of control over an associate distinguishes these from cases where own shares are held by a subsidiary. Note though that information about treasury shares held by associates must be disclosed in the notes to the financial statements.

Presentation

IAS 1.76

IFRSs do not mandate a specific method of allocating treasury shares within equity. Laws may prescribe the allocation method. Therefore, an entity should take into account its legal environment when choosing how to present its own shares within equity. Whatever local laws may require, an entity that claims compliance with IFRSs must comply with all requirements of IFRSs (see 1.1).

Possible alternatives are explained below; other methods also may be used. A variety of methods are used in practice. Whichever method is selected should be applied consistently to all treasury shares.

Total cost of treasury shares as a separate category of equity

In this case:

- the cost of treasury shares purchased is debited to a separate category of equity;
- when treasury shares are sold or reissued, the amount received for the shares is credited to this category; and
- any surpluses or deficits on sales of treasury shares are shown as an adjustment to share premium or reserves, including retained earnings, or a combination thereof.

This method is used in KPMG's *Illustrative financial statements* and in the illustrative statement of changes in equity above.

Par value of treasury shares as a separate category of equity

In this case:

- the par value of treasury shares purchased is debited to a separate category of equity;
- when treasury shares are sold or reissued, the par value of the shares is credited to this category; and
- any premium or discount to par value is shown as an adjustment to share premium or reserves including retained earnings, or a combination thereof.

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Par value of treasury shares as a deduction from share capital

In this case:

- the par value of treasury shares purchased is debited to share capital;
- when treasury shares are sold or reissued, the par value of the shares is credited to the share capital; and
- any premium or discount to par value is shown as an adjustment to share premium or reserves including retained earnings, or a combination thereof.

Allocate to all categories of equity

SIC 16.10(c) (1998)

Treasury shares, or adjustments arising from transactions in treasury shares, may be allocated to all categories of equity on a *pro rata* basis. In our view, other approaches are preferable as this one results in a complex allocation to each of the components of equity. In addition, adjustments to certain categories of equity will complicate the calculation of the amount of subsequent transfers from reserves, such as transfers from the foreign currency translation reserve and the cash flow hedging reserve.

3.10.8 Dividends

Dividends and other distributions to holders of equity instruments are recognised directly in equity and presented in the statement (or note) of changes in equity (see 3.10.5).

IAS 10.12, 37.20

A liability for dividends payable is not recognised until the entity has an obligation to pay dividends, which generally is not until they are declared or approved (if approval is required). In our view, a board decision to pay dividends does not in itself give rise to an obligation if further (e.g., shareholder) approval is required. A liability should be recognised only if the decision has been communicated, before the balance sheet date, to the shareholders. However, dividends may be shown as an appropriation of equity before they are recognised as a liability (see 2.9).

Dividends on shares, or components of shares, that are classified as liabilities (see 3.6) are recognised in the income statement as a financing cost. Even if the legal form of the payment is a dividend, it is not recorded directly in equity. Financing costs on shares, or components of shares, classified as liabilities are determined using the effective interest rate method.

Share dividends

IFRSs do not provide any guidance on accounting for share dividends (i.e., the issuance of additional shares to shareholders characterised as a dividend).

Sometimes shares with a value equal to the cash dividend amount are offered as an alternative to the cash dividend. When the shares are issued the liability is settled and a credit to equity is recognised as the proceeds of the issue. In our view, this practice is acceptable. Any reallocation of capital within equity will be in accordance with the law of the country of incorporation.

In our view, a stock dividend that is not an alternative to a cash dividend should be treated in the same way as a bonus issue.

3.10.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Statement of recognised income and expense

In April 2004, the IASB issued an exposure draft Amendments to IAS 19 *Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures*. The exposure draft includes proposals to require a statement of changes in equity including only recognised gains and losses (i.e., presented

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without a full reconciliation of all changes in equity). The statement would be called a Statement of recognised income and expense.

The exposure draft also proposes some equity classification requirements for actuarial gains and losses recognised directly in equity.

Classification of members' shares

In June 2004, IFRIC issued D8 *Members' Shares in Co-operative Entities*, which addresses the classification issue of members' interests which have characteristics of equity but they may also provide the holder with right to request redemption for cash or another financial instrument, subject to certain limitations. D8 provides guidance on how to evaluate these redemption terms when determining the classification of the financial instruments as a financial liability or equity.

Instruments puttable at fair value

During its June 2004 meeting the IASB discussed the classification of shares puttable at a *pro rata* share of the fair value of the residual interest in the issuer (referred to as shares puttable at fair value), including certain types of partnership capital. The IASB decided that IAS 32 requires all instruments that are puttable for cash or other assets to be classified as liabilities. It noted that for shares puttable at fair value, the application of IAS 32 may result in apparently anomalous accounting. This is true particularly when the fair value of the entity differs significantly from its recognised net asset value. The IASB therefore considered whether it should change IAS 32 to exempt shares puttable at fair value from classification as a liability. No proposals have been issued by the IASB to date.

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3.11 Provisions

(IAS 16, IAS 37)

Overview

- **A provision is recognised on the basis of a legal or constructive obligation, if there is a probable outflow of resources and the amount can be estimated reliably.**
- **A provision is measured at the best estimate of the anticipated outflow of resources.**
- **Provisions are discounted if the effect of discounting is material.**
- **A provision for restructuring costs is not recognised until there is a formal plan and details of the restructuring have been communicated to those affected by the plan.**
- **Provisions for repairs, maintenance or self-insurance are prohibited.**
- **A provision is recognised for a contract that is onerous (i.e., one in which the costs of meeting the obligations under the contract exceed the benefits to be derived).**

3.11.1 Definitions

IAS 37.10 A *provision* is a liability of uncertain timing or amount.

IAS 37.10 A *liability* is a present obligation that arises from past events, which is expected to result in the outflow of the entity's resources upon settlement.

IAS 37.11 *Accruals* are liabilities to pay for goods or services that have been received or supplied but not yet paid for or invoiced. The uncertainty of timing and amount generally is less for an accrual than for a provision. Examples are fees for services rendered such as audit or consulting fees and certain employee benefits such as vacation pay.

3.11.2 Scope

IAS 37.1 This section deals with all provisions other than restructurings recognised as liabilities in a business combination (see 2.6), deferred taxes (see 3.12), provisions for contract losses (see 4.2), provisions relating to employee benefits (see 4.4), liabilities for insurance contract obligations (see 5.10) and non-onerous executory contracts. Also see the related discussion of discontinuing operations in 5.4.

3.11.3 Recognition

IAS 37.14 A provision is recognised when:

- there is a legal or constructive obligation arising from past events, or in cases of doubt as to the existence of an obligation (e.g., a court case), when it is more likely than not that a legal or constructive obligation has arisen from a past event; and
- it is more likely than not that there will be an outflow of benefits; and
- the amount can be estimated reliably.

Obligating event

IAS 37.17 An integral part of an obligation is that it must arise from a past event.

IAS 37.18, 63, 66 Expected future operating losses, even if probable, are not provided for (unless they relate to onerous contract, see 3.11.7).

Similarly a provision is not recognised for sub-optimal profits. For example, in a regulated industry, good results in one period may result in lower prices being charged in the following period.

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However, no provision may be recognised in respect of the expected lower revenues because there is no obligating event.

A provision also may not be recognised for general business risks. Although losses may be probable, and the amount of the expected losses can be estimated, until there is an event of loss there is no obligating event. For example, P has announced to the public a business plan. As part of the plan P is entering new markets including Brazil, Russia and China. The new markets expose P to significant risk including currency risk and legal and political uncertainties. Although the plan has been made public, and may be virtually certain of being implemented, even if exit strategies are costly, P does not recognise a provision because there is no obligating event.

Legal obligation

IAS 37.10 Legal obligations normally arise from contracts or legislation.

IAS 37.22 Possible new legislation is taken into consideration only when it is virtually certain to be enacted. In practice new legislation normally does not give rise to an obligation until it is enacted because of uncertainties with respect to both whether it will be enacted and its final terms.

Constructive obligation

IAS 37.10 A constructive obligation arises where an entity, by past practice or sufficiently detailed public statements, has created a valid expectation in other parties that it will carry out an action.

For example, Y operates in the oil industry in a country that has no environmental legislation. However, Y has published an environmental policy indicating that it will clean up all contaminated sites and has, in the past, cleaned up such sites. Therefore, Y has a constructive obligation because its policy creates a valid expectation that it will clean up the contamination.

A management decision alone does not give rise to a constructive obligation, as it does not create a valid expectation in third parties until that decision is communicated to them. Therefore, a board decision does not trigger recognition of a provision.

IAS 37.19 Business reasons or legal requirements may mean that an entity intends or is required to incur expenditures in the future. However, an intention or future requirement does not result in an unavoidable obligation. For example, an entity may need to fit a purifier in an oil plant or retrain staff to comply with new laws. The expenditure could be avoided by future actions such as relocating its operations or hiring new staff, even if the entity does not plan to do so. Therefore, there is no obligating event.

Uncertainty about whether an obligation exists

IAS 37.15, 16 In some cases it may not be clear if an obligation exists, or (particularly in the case of a legal claim) an entity may dispute whether there is an obligation even if it is clear that there is a past event.

A past event gives rise to a present obligation if it is more likely than not that a present obligation exists at the balance sheet date. For example, F cans fish. A group of people is claiming that they suffered food poisoning from tuna canned by F. F disputes the claim. If it is more likely than not that F's tuna caused the food poisoning, then F is considered to have a present obligation, even if F is planning to defend its position.

Subsequent events that give rise to an obligation

IAS 37.21 An event that does not give rise to an obligation initially may give rise to one at a future date due to changes in the law or because an entity's actions create a constructive obligation.

For example, assume a new regulation is passed that imposes a requirement on V, a motor vehicle manufacturer, to accept back and scrap all vehicles it sells after 1 January 2005. A legal obligation to

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scrap the vehicles arises when the new legislation is virtually certain. The obligating events are sales of vehicles. V therefore recognises a provision for the present value of the expected costs of scrapping each vehicle that is sold after 1 January 2005. A provision is recognised as the vehicles are sold. No provision is recognised for vehicles in inventory at 1 January 2005, although the cost of scrapping would be considered in any net realisable value tests.

Extending the example, assume that the legislation requires the accepting back and scrapping from 1 January 2007 of all vehicles sold by it, *including* those sold before 1 January 2005. An issue arises as to when V has an obligation in respect of vehicles sold before 1 January 2005 and not scrapped by 31 December 2006. In our view, V should recognise a provision once it is virtually certain that the legislation will be enacted; the specific terms of the legislation are known; and it is possible to estimate the number of vehicles that will be in use and the scrapping costs. The obligation arises when the legislation is enacted or becomes virtually certain of being enacted and the obligating events are the past sales.

Obligation dependent on future events

IAS 37.19 If the existence of an obligation depends on the future actions of the entity, a provision should not be recognised until the obligation is unavoidable.

For example, as in the previous example, a new regulation is passed that imposes an obligation on motor vehicle manufacturers in respect of scrapping costs. However, instead of being responsible for scrapping the vehicles, V will be required to pay a scrapping levy to the government. The scrapping levy in respect of vehicles sold before 2005 will be based on vehicle manufacturers' market share in 2007 regardless of their actual sales in previous periods. V could avoid the obligation, for example, by selling vehicles in a different market. Therefore, in our view, the obligating event in this case occurs only in 2007 as V makes sales that establish its market share, and therefore its share of the costs of scrapping historical production by all manufacturers.

Counterparty

IAS 37.20 An obligation always involves another party. However, an entity is not required to be able to identify the counterparty to the obligation before a provision is recognised.

3.11.4 Measurement

IAS 37.36 The amount provided is the best estimate of the expenditure to be incurred. It is not acceptable to have an accounting policy of measuring the provision based on the lowest or the highest anticipated outcome.

IAS 37.39 If there is a large population, such as for product warranties, the provision is measured at its expected value. Expected value considers all possible outcomes weighted based on their probabilities. If there is a continuous range of possible outcomes, and each point in the range is equally likely, a provision is recognised for the mid-point in the range.

IAS 37.40 If there is a single item, the most likely outcome usually is the best estimate. For example, if there is a 60 per cent probability that D will have to pay damages of 600,000 in a legal case the provision is measured at 600,000 because D will either win (and pay nothing) or lose and pay 600,000; not at 360,000 (600,000 x 60 per cent + 0 x 40 per cent).

However, in some cases it will be necessary to consider other outcomes, even when a single obligation is measured. For example, G has an obligation to rectify a fault in a plant constructed for a customer. The cost of the repair could range from 70,000 to 130,000. The provision should be measured based on the expected repair cost, which may be anywhere between 70,000 and 130,000. When a provision is measured at its best estimate, which is less than the amount that could be payable, the difference between the two amounts is *not* a contingent liability. For example, if it was

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determined in the above example that the provision should be measured at 90,000, the remaining possible amount of 40,000 would not be a contingent liability (see 3.13).

Risk and discounting

IAS 37.45, 47 If the effect is material, the estimate is discounted at a pre-tax rate that reflects the time value of money and the risks specific to the liability (unless the future cash flows are adjusted for these – see below).

IAS 37.47 Risk is reflected either by adjusting the cash flows or the discount rate. In our experience, generally it is easier to adjust the cash flows for risk and to discount the expected cash flows at a risk-free interest rate. Adjusting the discount rate for risk often is complex and involves a high degree of judgement.

The risk-free rate may be determined by considering the interest rate on a government bond in the same currency and with a similar maturity to the obligation.

If an entity has set aside assets to fund an obligation, and the assets are intended to generate a sufficient return to meet the ultimate obligation, an issue arises about whether the rate of return on the assets in the fund may be used as a risk-adjusted discount rate for the obligation. The variability of the cash flows on the liability normally is not correlated to the variability of the cash flows on the assets. Therefore, the return on the assets does not reflect the risks specific to the liability and, in our view, should not be used to discount the provision.

Inflation adjustments

IAS 36.40 The standard provides no guidance on whether the discount rate should include the effects of inflation. In our view, if the cash flows are expressed in current prices the effects of inflation should not be included in the discount rate. If the cash flows include inflation, the discount rate should include the effects of inflation.

In our experience it is simpler to use current prices and to exclude the effects of inflation in the discount rate.

Tax impact

A pre-tax discount rate should be used because provisions are measured on a pre-tax basis. Any tax impact is accounted for separately (see 3.12).

Remeasurement

IAS 37.36, 59 Provisions must be remeasured at each balance sheet date based on the best estimate of the settlement amount.

IAS 37.84(e) IFRSs do not address directly the issue of remeasurement of provisions at each balance sheet date for changes in interest rates; however, it is an implicit requirement as disclosure of changes in the measurement of a provision due to any change in the discount rate used is required. In our view, provisions should be remeasured at each balance sheet date for changes in interest rates, if this has a material impact#.

Forthcoming requirements

IFRIC 1 In May 2004, IFRIC issued IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. The interpretation requires the effect of any changes to an existing obligation, including those resulting from changes in the discount rate used, to be added to or deducted from the cost of the related asset and depreciated prospectively over the asset's useful life (see 3.2). IFRIC 1 also confirms that provisions must be remeasured at each balance sheet date.

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Future events

IAS 37.48 Future events should be taken into account in measuring a provision if there is sufficient objective evidence that they will occur. For example, a technological development that would make decommissioning less expensive would be considered if there is evidence that the new technology will be available.

Gains

IAS 37.51 Gains from the expected disposal of assets should not be considered when measuring a provision.

Therefore, if a provision is recognised for a restructuring (see 3.11.7), gains on the related sale of any assets should not be considered in measuring the provision. As a result restructuring costs are likely to be recognised earlier than the gain on the related sale of assets.

For example, an entity commits to a restructuring to outsource its distribution activities. This will involve closing one of its warehouses and cancelling leases of equipment used in the warehouse. The entity expects to sell the closed warehouse for a gain that exceeds the cancellation penalties on the equipment leases. The expected gain from the sale of the warehouse cannot be used to reduce the provision for the lease cancellation costs.

Associated costs

IAS 37.18, 36 IFRSs do not provide much guidance regarding the types of costs to be included in the measurement of a provision. Accrual of costs that need to be incurred to operate in the future is prohibited. However, provisions are to be measured based on what an entity rationally would pay to settle or transfer the obligation.

In our view, anticipated *incremental* costs that are related directly to the settlement of a provision should be included in the measurement of the provision to the extent that a third party who assumes the liability would require compensation. This is likely to be the case when the incremental costs are probable and can be estimated reliably.

Incremental costs are those in addition to normal operating expenses. Therefore, in our view, costs that are not incremental should not be included in the measurement of a provision, even if there is a reasonable basis for allocating a portion of these costs to the settlement of the provision. For example, costs to be incurred irrespective of a specific claim, such as salaries of employees in the claims department, are future operating costs and are excluded from the measurement of a provision.

In our view, the above principle applies to both external and internal costs. However, internal costs often are not incremental and therefore should not be included in the measurement of a provision.

For example, entity A maintains a risk management department that handles damage claims. The costs of the department are unlikely to be incremental for any one claim and therefore should not be included in the measurement of the provision for expected claims. However, if A engages an external advisor to negotiate a settlement of a specific matter, this cost is incremental and normally would be included in the measurement of the related provision.

3.11.5 Reimbursements

IAS 37.53 Reimbursements (such as insurance recoveries, indemnities or warranties) are recognised as a separate asset when recovery is virtually certain. The amount recognised is limited to the amount of the related provision.

For example, one of M's customers has won a claim against M for 300,000 in respect of a defective product it purchased from M. M can recover the cost of the defect and a penalty of 12 per cent from the supplier. The supplier has confirmed that it will pay 336,000 (300,000 + 12 per cent x 300,000) to M as soon as M has paid the customer. M should recognise a provision for the claim of 300,000.

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Since the reimbursement is virtually certain it should be recognised as a separate asset. However, the amount recognised should not exceed the amount of the provision recognised for the claim (i.e., 300,000). The expense and the reimbursement may be netted in the income statement; however, the asset and the provision cannot be netted in the balance sheet and must be disclosed separately. M should disclose the unrecognised reimbursement of 36,000 as a contingent asset in the notes to the financial statements (see 3.13).

If the amount of a reimbursement cannot be determined, or the party that will make the reimbursement cannot be identified, the reimbursement generally is not virtually certain.

In practice an obligation and the related recovery normally are recognised at the same time.

If the only uncertainty regarding the recovery of an insured loss is the amount of the recovery, in our view, the reimbursement often will qualify to be recognised as an asset. For example, Y has recognised a provision for environmental contamination that it must clean up. Y's insurance company has confirmed that the accident that caused the contamination is an insured event, but has not yet finalised the settlement amount. Y should recognise its best estimate of the reimbursement (not exceeding the amount of the provision) as a separate asset.

This area of IFRSs may be subject to future developments (see 3.11.9).

3.11.6 Changes in and use of provisions

IAS 37.59 Provisions shall be reviewed at each balance sheet date and adjusted to reflect management's best estimate.

IAS 37.61 Only expenditures related to the original nature of the provision can be set against it.

3.11.7 Specific application guidance

Restructuring

IAS 37 contains specific guidance on its application to restructuring provisions. This guidance is an illustration of how the principles in the standard apply to issues that arise frequently in connection with a restructuring.

This area of IFRSs may be subject to future developments (see 3.11.9).

Definition

IAS 37.10 A restructuring is defined as a programme planned and controlled by management that materially changes the scope of the business or the manner in which it is conducted.

Obligating event

IAS 37.72 A constructive obligation for a restructuring arises only when:

- there is a formal plan for the restructuring specifying:
  - the business or part of a business concerned;
  - the principal locations affected;
  - the location, function and approximate number of employees whose services will be terminated;
  - the expenditure to be incurred; and
  - when the plan will be implemented (see below for additional comments on timing); and
- the entity has raised a valid expectation in those affected that it will carry out the plan by either:
  - starting to implement the plan; or
  - announcing its main features to those affected by it.

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These requirements apply to all restructuring costs other than redundancy payments and pension plan changes (see 4.4), costs of restructuring an acquired business (see 2.6) and the impairment of assets as a result of a restructuring (see 3.9).

Sale transactions

IAS 37.78 An obligation related to the sale of an operation arises only when there is a binding sale agreement. Therefore, even if the decision to sell an operation has been announced, no provision is recognised for obligations arising as a result of the sale until there is a binding sale agreement#.

Certain sale transactions may be subject to regulatory or shareholder approval. In these cases the sale agreement normally is binding unless the approval is not obtained. In our view, a provision triggered by a sale agreement should be recognised once the agreement is finalised if it is more likely than not that the necessary approval will be obtained.

Forthcoming requirements

IFRS 5 In March 2004, the IASB issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, which provides guidance on the measurement of non-current assets (and disposal groups) classified as held for sale (see 5.4A).

Announcement

IAS 37.17(b), 72(b) Although IAS 37 does not prescribe the contents of the announcement, it does require the announcement to have created a valid expectation in those affected that the plan will be implemented.

In our view, the announcement should include information about:

- the business or part of the business that is affected;
- the estimated timing; and
- the functions and approximate number of employees affected.

In cases when the business is carried out in several locations, the affected locations also should be specified. However, we do not believe that it is necessary for the estimated cost of the restructuring to be included in the announcement, since this is unlikely to be a key factor in raising an expectation that the restructuring will go ahead.

Counterparty

IAS 37.20 As noted previously, IFRSs do not require an entity to know the identity of the counterparty to the obligation before a provision must be recognised. Therefore, it is not necessary to notify individual counterparties (e.g., each employee or vendor) before a provision is recognised. However, both the plan and the announcement of the plan must have sufficient detail for those affected to identify the potential impact and to understand what their claim may be.

Timing

IAS 37.74 For a plan to create a constructive obligation, implementation should begin as soon as possible.

There is no specified limit on the timing. The time frame should be short enough that the plan is concrete and the possibility of it being changed is small. The longer the time frame, the more difficult it will be to demonstrate that it is highly unlikely that the plan will be changed.

Contractual requirement to restructure

An entity may enter into a contractual agreement to undertake a restructuring (e.g., as a result of an outsourcing arrangement).

For example, K outsources its IT processing function to L. L will take over K's existing IT department and restructure it. Under the terms of the outsourcing contract, K agrees to reimburse L for all costs

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associated with the restructuring. In our view, entering into the outsourcing contract creates a valid expectation in a third party (L) that K will carry out the restructuring. However, we view the outsourcing agreement as an executory contract. Therefore, the costs should be recognised as L performs under the contract, and not on signing the contract unless the contract is onerous. K would recognise a liability for its obligation to reimburse L once L recognises its restructuring obligation (e.g., upon communication to impacted employees).

Group-wide restructuring

An entity that has a group-wide restructuring might not meet the criteria for recognising a provision for all of the locations at the same time.

In our view, the criteria should be applied to each part of the restructuring programme (e.g., each location) separately. Provisions should be recognised only for those locations that meet the criteria.

Board decision

IAS 37.77 Generally a board decision in itself does not establish a constructive obligation, for example, with respect to the termination of employees.

However, a board decision may require communication with a decision-making body that includes employee representatives (e.g., a supervisory board). In such cases, approval of the plan by the supervisory board probably results in a constructive obligation even if there is no direct communication to the affected employees at that time.

Measurement

IAS 37.80 Restructuring provisions include only incremental costs associated directly with the restructuring. Examples of costs that should be included in measuring the provision include employee termination benefits relating directly to the restructuring (see 4.4), contract termination costs (such as lease termination penalties) and onerous contract provisions (see below), directly related consulting fees, and expected costs from when operations cease until final disposal.

IAS 37.80(b) IFRSs prohibit recognition of a provision for costs associated with ongoing activities. Therefore, provisions are not recognised for:

- expected future operating costs or expected operating losses (unless they relate to an onerous contract, see below);
- gains or losses on expected disposals or impairments of assets;
- investment in new systems;
- lower utilisation of a facility;
- costs of training or relocating staff;
- staff costs for staff that continue to be employed in ongoing operations;
- loyalty bonuses or amounts paid to staff as an incentive to stay;
- costs of moving assets or operations;
- administration or marketing costs;
- allocations of corporate overheads; or
- costs of changing the name of an entity.

For example, C is a dairy but also produces cheese. The cheese making operations are being restructured. The equipment that is used in the cheese making operations will be redesigned and staff will be trained to use the new equipment. To the extent that the restructuring relates to C's ongoing operations, a provision is not recognised for these costs. Costs of new equipment and costs of improvements to existing equipment should be capitalised when incurred (see 3.2). Other costs related to the restructuring should be expensed as incurred.

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Employee termination payments

See 4.4 for guidance on accounting for employee termination payments.

Asset disposals# or impairment

A restructuring also may entail asset disposals or trigger impairment of assets. Issues related to impairment of assets are dealt with in 3.9.

Forthcoming requirements

IFRS 5 In March 2004, the IASB issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, which provides guidance on the measurement of non-current assets (and disposal groups) classified as held for sale (see 5.4A).

Warranties

IAS 37.C1 An entity that has an established practice of repairing or replacing, even if legally it is not obliged to do so, faulty or defective goods that are returned generally has a constructive obligation to repair or replace products. The obligating event is the sale of goods that turn out to be defective or faulty.

IAS 37.C1 A warranty provision is measured based on the probability of the goods requiring repair or replacement and the best estimate of the costs to be incurred in respect of defective products sold on or before the balance sheet date.

For example, M manufactures and sells luxury vehicles. All vehicles are guaranteed for 12 months. M introduced a new model, the R100, two months before the reporting date. When the financial statements are prepared, no claims have been made in respect of the new model. However, based on previous experience with other similar models, it is probable that there will be claims for manufacturing defects. M should recognise a provision in respect of expected claims on the new model. The lack of claim history in respect of the R100 does not change this (the sale of the defective vehicles is the obligating event). M should consider claim patterns in respect of other comparable models to determine the expected number of claims and the anticipated cost.

In our view, *incremental* staff costs that are directly attributable to handling individual warranty claims (e.g., amounts paid to contractors for call outs or overtime pay) should be included in the measurement of provisions. However, costs that are not related to a specific warranty claim (e.g., the cost of maintaining a claims department) are not incremental and therefore should not be included in the measurement of the provision.

Customer refunds

IAS 18.16(d), 17, 18.A2(b) An obligation to give refunds to unsatisfied customers is considered in determining whether to recognise revenue (see 4.2). If the right of return does not result in the seller retaining significant risks of ownership and a return is not probable then revenue may be recognised.

IAS 37.C4 A past practice or published policy of giving refunds to dissatisfied customers creates a constructive obligation. The obligating event is the sale of the product. If it is probable that a certain portion of the goods sold will be returned, a provision is recognised (at the same time as the revenue is recognised) for the best estimate of the cost of refunds, applying the same principles to those for warranty provisions (see above).

Self-insurance

Entities may elect not to insure against some risks, or to obtain insurance that only covers a certain portion of incurred losses (e.g., due to high deductibles); sometimes this is referred to as self-insurance.

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A provision is not recognised for future losses or costs associated with self-insurance. However, a provision should be recognised for costs related to events (insured or not) that occur before the balance sheet date.

For example, D operates a chain of fast food outlets and decides not to insure against the risk of third party liability claims. Instead D will self-insure this risk. Based on past experience, D expects losses of 100,000 each year in respect of third party liability claims. In the first year of self-insurance, actual claims are 80,000 and the deadline for making such claims has passed. A provision may not be recognised for the additional average claims of 20,000, if it is reasonably certain that all incurred losses have been reported. Although it may be possible to estimate average annual expected claims reliably, there is *no obligating event* in the current year.

However, a provision should be recognised for losses that have been incurred, but not yet reported, at the reporting date (commonly referred to as IBNRs), if there is a probable outflow of economic benefits and a reliable estimate of the losses can be made. For example, if the entity believed that injuries had occurred for which 25,000 of additional claims would be made, it should accrue that 25,000. This is because, although the entity has not yet received these claims, an obligating event has occurred. In our view, the calculation should take into account statistical experience of such events and the related amounts. Principles similar to those applied in the insurance industry may be used to measure IBNR provisions.

Risks assumed on behalf of third parties

IAS 37.1(e) The obligations arising under an insurance contract are outside the scope of IAS 37#. This scope exclusion is not limited to entities regulated as insurance companies.

For example, L owns and rents out properties. Under the rental agreement L is responsible for repairing the properties in the case of fire. The rental includes a risk premium in respect of the possible loss due to fire. In our view, the properties are L's assets and therefore L should not recognise a provision for expected future damage (e.g., future fires). Any further obligations (e.g., for damage to tenants' belongings) are an insurance contract outside the scope of IAS 37. An entity could apply the principles of the Framework and recognise a provision for estimated liabilities for damage incurred to date. Other insurance industries practices, which may include recognising a provision for probable future claims, also could be applied (see 5.10). In any case L could not recognise a provision for expected future damage to its own assets.

The scope exemption for insurance contracts applies only where risks are assumed on behalf of third parties. Risks assumed on behalf of group entities give rise to self-insurance and are within the scope of IAS 37.

Forthcoming requirements

IFRS 4 In March 2004, the IASB issued IFRS 4 *Insurance Contracts* (see 5.10). The new standard does not deal with the recognition and measurement of obligations arising from self insured risks.

Captive insurance entities

In some cases separate entities are established for self-insurance arrangements. These may be subsidiaries or SPEs. The administration of the entity often is handled by a third party insurance entity.

The guidance on consolidation (see 2.5) is applicable in determining whether such entities, often referred to as "insurance captives", should be consolidated.

If the insured entity continues (directly or indirectly) to bear the risk of the insured losses, it should consolidate the insurance captive. Therefore, the principles described above for self-insurance would apply, and the insured entity would recognise a provision only when an event of loss occurs, and

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only for obligations incurred. For example, a self-insured entity would recognise impairment losses for property damaged in a fire rather than a provision to repair the property.

If an arrangement transfers the risk of losses to an unrelated third party, the arrangement has the same economic substance as an insurance contract. Therefore, the arrangement should be accounted for in the same way as an insurance policy. An insurance policyholder recognises premiums as an expense over the period of the insurance. Provisions for losses are recognised only once the loss occurs and reimbursement rights are recognised as separate assets (see 3.11.5).

Environmental provisions

IAS 37.14 The recognition and measurement of a provision for environmental obligations follows the general requirements described in 3.11.3 and 3.11.4. Therefore, a provision should be recognised when there is either a legal or constructive obligation to restore a site; the damage already has occurred; it is probable a restoration expense will be incurred; and the costs can be reasonably estimated.

Obligating event

IAS 37.10 A constructive obligation may arise from published policies, past practices of environmental clean ups or statements about clean-up policies made in the press or to the public.

In-house standards and practices result in a constructive obligation only if they are communicated to third parties.

For example, although no legal obligation exists, the board of G has instructed local management to clean up a site where land and ground water have been contaminated. The estimated cost of the clean up is 250,000. If G does not have an established practice or published policies, that would demonstrably commit it to clean up the site, no provision should be recognised based on the board decision alone. The board decision and instruction to clean up the site does not result in a constructive obligation if that decision is not communicated externally. The decision still could be reversed and the costs avoided.

IAS 37.22 Future changes in environmental legislation should not be taken into account unless they are virtually certain of being enacted.

Measurement

IAS 37.36 A provision should be measured at the best estimate of the future clean-up costs. It should reflect the amount that the entity would be required to pay to settle the obligation at the reporting date.

In our experience, making the estimate may require a specialised knowledge of environmental issues, for example, the quantity and type of contaminants involved, the local geography and remediation costs. The estimates typically need to be made by environmental experts.

IAS 37.49 Anticipated cost savings arising from future improvements in technology should be considered in measuring the provision only if its existence is reasonably certain.

The provision should include estimated incremental direct costs; for example, amounts paid to consultants, costs of equipment dedicated to the clean up, and costs of employees performing the clean-up effort. In our view, the costs of the following activities should be included when measuring the provision:

- remedial investigation;
- risk assessment;
- feasibility studies;
- preparation of a remedial action plan;
- remediation work;

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- government oversight costs; and
- post-remediation monitoring.

IAS 37.45 Outflows in respect of environmental provisions may occur far in the future. Therefore, the effects of discounting may be significant and, if so, the provisions should be measured at the present value of expected cash flows.

Decommissioning

IAS 37.14 The obligation to make good environmental or other damage incurred in installing an asset is provided for in full immediately since the damage arises from a past event – the installation of the asset. For example, a provision is recognised for the expected cost of dismantling an oil-rig when it is installed.

IAS 16.16(c) When an obligation to restore the environment or dismantle an asset arises on the initial recognition of the asset, the corresponding debit is treated as part of the cost of the related asset and is not recognised immediately in the income statement (see 3.2)#.

IAS 37.14 If an obligation to dismantle or decommission an asset or restore the environment arises after the initial recognition of the asset, a provision is recognised at the time the obligation arises. In our view, the estimated cost should be recognised as an adjustment to the cost of the asset and depreciated prospectively over the remaining useful life of the asset. However, the increase in cost may require recognition of an impairment loss if that additional cost is not recoverable. See 3.2 for additional guidance and an example.

In our view, if the obligation arises only at the end of the useful life of the asset, the cost should be recognised immediately as an expense. For example, Q operates a brewery close to the city centre. In 2005, due to new town planning restrictions, Q is required to immediately cease operations, move the brewery out of the town centre and clean up the site. Previously Q had not recognised a provision for the clean up, as there was no obligation. Q should recognise a provision for the site clean up and a corresponding expense when the government informs them of the need to move and clean up the site. In our view the cost should not be recognised as an asset as it will not benefit future periods.

Forthcoming requirements

IAS 16.16(c) The revised standard clarifies that the cost of an item of property, plant and equipment includes not only the ‘initial estimate’ of the costs relating to dismantlement, removal or restoration of property, plant or equipment at the time of *installing the item* but also during period of the *use*, for purposes other than producing inventory (see 3.2), for example changes in the original estimate of dismantlement, removal or restoration costs.

IFRIC 1 In May 2004, IFRIC issued IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. The interpretation requires the effect of any changes to an existing obligation to be added to or deducted from the cost of the related asset and depreciated prospectively over the asset’s useful life (see 3.2).

The interpretation does not address how to account for new obligations, for example, those triggered by a law enacted after the asset was acquired.

Discounting

IAS 37.45 Decommissioning, like remediation of certain environmental damage, often will take place only far in the future. Therefore, the effects of discounting normally are material for decommissioning liabilities.

Timing of outflow

In determining the expected timing of the outflow, the expected useful life of the related asset should be considered.

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In our view, assumptions about future events should be supported by objective evidence because of the uncertainty of predicting events far into the future. For example, Y has a chemical production plant with an anticipated useful life of 25 years. At the end of the useful life it is possible that Y will construct a new production plant with a 25 year useful life on the site, in which case decommissioning will take place only in 50 years. Unless there is evidence that a new plant will be constructed, we believe that Y should assume that the decommissioning will take place in 25 years.

The assumptions also should be consistent with the other assumptions regarding the use of the asset. For example, T is required to remove an oil-rig as soon as it ceases pumping oil. If the estimated remaining useful life of the oil-rig is 10 years, T should assume that the decommissioning will take place in 10 years, even if there is a possibility that the oil-rig may be used for longer.

An entity may not be required to (and may not be able to) decommission an asset immediately after it ceases using the asset. In this case, the best estimate of the timing of the cash flows should be used to measure the present value of the obligation.

Past versus future events

A provision is recognised only if there are past events. Therefore, a provision should reflect only damage incurred at the reporting date; a provision is not recognised for expected future damage.

For example, U operates a nuclear power plant. The nuclear power plant was constructed in 2003 at a cost of 10,000,000. The estimated present value of the costs of dismantling the power plant and restoring the site for the damage caused by its construction at the end of its 25 year useful life is 980,000. In addition, there will be ongoing damage to the environment by the emission of various gases throughout the operating life of the power plant, which is expected to require remediation costing 175,000 each year.

The obligation to dismantle the power plant and restore the site (980,000) is created in December 2003 when the power plant is constructed. The obligation in respect of the ongoing emissions arises as the emissions occur (i.e., over the useful life of the power plant).

The following are the accounting entries that U should record in respect of the environmental damage:

In December 2003, when the nuclear power plant is constructed:

	Debit	*Credit*
Nuclear power plant	980,000	
Obligation for remediation		980,000
Recognise liability for anticipated cost of site restoration and dismantling as part of the cost of the asset		

At 31 December 2004, assuming a 10 per cent discount rate:

	Debit	*Credit*
Interest cost (income statement)	98,000	
Obligation for remediation		98,000
Accrue interest on liability for site restoration and dismantling (10 per cent x 980,000)		
Depreciation of power plant (income statement)	439,200	
Accumulated depreciation power plant		439,200
Recognise depreciation of power plant (10,980,000/25)		

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	Debit	Credit
Operating costs (income statement)	175,000	
Obligation for remediation		175,000
Recognise liability in respect of the emissions during the period		

In each of the following years during the useful life of the power plant, U will recognise:

- Depreciation on the power plant of 439,200 (10,980,000/25).
- A provision for the emission damage during the year of 175,000.
- An interest cost based on 10 per cent of the accumulated obligation (for decommissioning and emissions damage) at the beginning of the year. Therefore, in 2005, U will recognise an interest cost of 125,300 ((980,000 + 98,000 + 175,000) x 10 per cent).

Changes in estimate

In our view, adjustments to the amount of a provision for dismantling costs caused by changes in estimates and changes in the discount rate should be treated as an adjustment to the cost of the related asset and depreciated prospectively over the remaining useful life of the asset (i.e., treated as a change in estimate, see 2.8)#.

Forthcoming requirements

IFRIC 1 In May 2004, IFRIC issued IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. The interpretation requires the effect of any changes to an existing obligation to be added to or deducted from the cost of the related asset and depreciated prospectively over the asset's useful life (see 3.2). The interpretation does not address how to account for new obligations, for example, those triggered by a law enacted after the asset was acquired.

Environmental and similar funds

Sometimes funds are established to finance environmental or other remediation costs. For example, in order to ensure that nuclear power plant operators have funding available to finance decommissioning costs, the government may require operators to make contributions to a fund. A fund may be set up to meet the decommissioning costs of a single contributor, or several contributors. The operator may have no control over the investment decisions of the fund and if the amount in the fund is insufficient to cover the decommissioning costs, the operator bears the additional costs.

The operator normally continues to bear the primary obligation for the decommissioning and therefore should continue to recognise a provision for its obligation.

The operator's investment in the fund should be accounted for as an asset. If the fund is a subsidiary, joint venture or associate of the operator, it should be consolidated, proportionately consolidated or accounted for using the equity method as appropriate (see 2.5 and 3.5). Otherwise, in our view, the asset should be measured at fair value with changes in value recognised in the income statement. This area of IFRSs may be subject to future developments (see 3.11.9).

For guidance on the balance sheet presentation of the asset (see 3.11.8).

Repairs and maintenance

IAS 37.C11 Repairs and maintenance of own assets cannot be provided for since these are costs associated with the future use of the assets. These costs generally are expensed as incurred.

Shut downs

Some entities periodically shut down facilities for repairs and maintenance. For example, Z operates a chain of hotels. Every three years Z closes the hotel for three months to perform repairs and maintenance. A provision cannot be recognised in respect of future repairs and maintenance, even

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though the costs can be estimated reliably and the repairs and maintenance are probable because they are necessary for Z to continue in operation. Until the expenditure is incurred, there is no obligating event (i.e., the expenditure is avoidable). The repairs and maintenance costs should be expensed when incurred unless the activity creates a separately recognisable component of the hotel (see 3.2).

Legal requirement

The prohibition on recognising a provision for future repairs and maintenance also applies when there is a legal requirement to undertake the specified repairs and maintenance activities.

For example, aviation law requires aircraft overhauls after a fixed number of flight hours. However, the overhaul can be avoided if the aircraft is withdrawn from use when (or before) it has flown the specified number of hours. Therefore, the cost of the overhaul is recognised only when the work is done.

As another example, in the United Kingdom, entities operating in the water industry agree a programme of maintenance with the regulator. If an entity does not spend the agreed amount within the specified period, the regulator can require the water company to reduce the amount it charges to customers. Both the future maintenance cost and any enforced reduction in revenues are future costs and therefore a provision cannot be recognised for these costs. Instead the costs and revenue reduction are recognised as they are incurred.

Major inspection or overhaul costs

IAS 16.14 When assets are subject to a major inspection or overhaul, a component approach to depreciation should be applied. See 3.2 for an explanation and an example of when the components approach should be applied.

The components approach often may result in capitalisation of major inspection and overhaul costs and amortisation of those capitalised costs over the period until the next major overhaul.

Replacement costs

A provision may not be recognised for the cost of replacing items of equipment that will be consumed in operations (e.g., the cost of replacement linen or crockery in the hospitality business).

Instead, the cost of the replacement items should be recognised as equipment and depreciated (if the items will be used for more than one period (see 3.2)), or as inventory when they are purchased or produced. See also 3.7 for comments on using the base stock method to account for such items.

Third party maintenance contracts

Sometimes an entity will enter into a contract with an unrelated party to provide maintenance services (e.g., a lessor may agree to maintain a leased asset). In our view, the contract is executory and the service provider should not accrue for the expected cost of meeting its obligations under the contract unless the contract is onerous (see below). The relevant costs should be recognised only when the services are performed. For additional guidance on accounting for the service element of lease payments see 5.1.

Similarly, we do not believe that the customer (the lessee) should recognise a provision for the maintenance costs payable under the contract. The repairs and maintenance contract is a service contract (an executory contract) and, normally, obligations under such contracts are not recognised until the service is provided, unless the contract is onerous. Rather the customer should accrue the costs only when they are due.

IAS 37.18 For example, D is a manufacturer and retailer of motor vehicles. D offers customers the option of a service contract. Customers who elect to have a service contract pay a higher price for the vehicle. Under the terms of the service contract D maintains and services the vehicle for three years from

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the purchase date. In our view, D should not recognise a provision for the future service costs, unless the contract is onerous. Instead the portion of the selling price that relates to the service contract should be deferred (see 4.2 for additional guidance).

Maintenance of leased assets

Lease contracts sometimes require the lessee to maintain the leased asset. In our view, the appropriate accounting treatment of the maintenance costs depends on the nature of the costs, whether the lease is classified as a finance or an operating lease (see 5.1), and the terms of the lease agreement.

Hand-back costs

IAS 17.25

In our view, when the lessee is required to restore a leased asset to its original condition at the end of the lease term, the obligation to incur the hand-back cost arises as the lessee uses the asset. Therefore, we believe that hand-back costs should be accrued over the lease term in the same way as lease payments under an operating lease. At each balance sheet date the provision should be measured at the expected cost of restoring the asset to the required condition at that date.

Assets leased under a finance lease

The substance of a finance lease is the purchase of an asset and a financing transaction (see 5.1). The accounting for a finance lease reflects this substance. Therefore, in our view, the lessee should account for any overhauls or repairs and maintenance costs associated with an asset leased under a finance lease in the same way as it would for such costs related to its own assets.

As such, the lessee should apply the components approach to accounting for a leased asset that is subject to major repair or overhaul costs (i.e., the costs should be capitalised and depreciated over the useful life of the component (see 3.2)). Other repair and maintenance costs should be expensed as incurred.

Assets leased under an operating lease

The issues are more complex for an asset leased under an operating lease because the asset and the future obligations under the lease are not reflected on the lessee's balance sheet. There is no guidance in IFRSs on whether component accounting is appropriate when the principal asset is not recognised in the financial statements.

In the case of an asset leased under an operating lease with an obligation to deliver the asset (or parts of the asset) back in its original condition, the operating lease payments will not reflect fully the consumption of the asset during the lease term. In other circumstances operating lease payments will include payments that reflect the original condition of the asset and its anticipated condition at the end of the lease term. In our view, the nature of the transaction determines whether the entity should:

- Apply the components approach and recognise major repair or overhaul costs as a leasehold improvement. This approach may be applied on initial recognition to the extent repair or overhaul costs are included in the lease payments, effectively treating a part of the lease contract as a finance lease (or owned asset) and the other part as an operating lease contract. Other maintenance costs are recognised as an expense when incurred.
- Recognise a provision for the maintenance cost over the period of the lease as the original component is consumed (for the contractual obligation to hand back the asset in the original condition). This approach should be applied when the operating lease payments do not include payments for repair or overhaul costs. The approach also may be applied when repair or overhaul costs are included in the lease payments. In our view, for this approach to be applied, the lease agreement should establish a clear obligation for the lessee to incur expenditure proportionate to the use of the asset. The provision would be measured at the cost that the lessee would incur if the lease were terminated at the balance sheet date.

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To illustrate the two approaches above, assume that T leases a property under an operating lease. The property has been refurbished two years before the lease commences. T is required to fully refurbish the building every five years.

If the building may be handed back with a five year old refurbishment then three years of refurbishment is included in the lease payments and the component approach may be applied. Under this approach, an asset (and a liability) would be recognised on initial recognition of the lease. Subsequently, when the refurbishment costs are incurred, T would capitalise those costs as leasehold improvements and depreciate the component over the period to the next refurbishment. The component should not include costs of day-to-day servicing.

In our view, if the building is required to be handed back newly refurbished then the liability approach should be applied. Under this approach, T would recognise a provision for the refurbishment costs. The provision would be measured at the expected cost of the refurbishment based on the condition of the building at each balance sheet date. This results in a provision being recognised for the full cost of the refurbishment at the end of each five-year period.

Onerous contracts

Definition

IAS 37.10 An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be derived.

A contract on unfavourable terms is not necessarily onerous. For example, B is the lessee of properties under operating leases. The lease payments on a number of the properties exceed normal market rentals for properties in the area. B does not have an onerous contract as long as the lease payments do not exceed the benefits it will derive from the properties.

Similarly, a contract that is not performing as well as anticipated, or as well as possible, is not onerous unless the costs of fulfilling the obligations under the contract exceed the benefits to be derived.

Determining whether a contract is onerous

IAS 37.10 In assessing whether a contract is onerous it is necessary to consider:

- the unavoidable costs of meeting the contractual obligations, which is the lower of the net costs of fulfilling the contract or the cost of terminating it; and
- the economic benefits expected to be received.

Costs

In determining the costs of fulfilling the contract, the payments due in the period in which the contract cannot be cancelled should be considered. If there is an option to cancel the contract and pay a penalty, the present value of the amount to be paid on cancellation of the contract also should be considered.

To illustrate, F leases office space for an annual rental of 20,000. The remaining lease term is five years, although after two years F has an option to cancel the lease and pay a penalty of 25,000. The cost of fulfilling the contract is 75,000 (the present value of 20,000 x 5). The cost of terminating the contract is 60,000 (the present value of (20,000 x 2 + 25,000)). Therefore, the alternative that results in the lowest cost should be used in determining whether the contract is onerous is 60,000.

In our view, only unavoidable operating costs directly associated with meeting the entity's obligations under the contract should be considered in determining whether the contract is onerous (and measuring any resulting provision). Costs that could be avoided by the entity's future actions (such as avoidable maintenance costs) and costs related to continuing business should not be considered. For example, A services computers and charges clients a fixed monthly fee. On one of the contracts

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the servicing requirements are significantly higher than anticipated. In determining whether the contract is onerous, A should consider the direct variable costs that it would need to incur to meet its obligations under the contract, but not costs that relate to the servicing business as a whole.

In some cases, costs may relate to more than one contract. IFRSs are silent as to how costs should be allocated between contracts in determining whether a contract is onerous. In our view, any reasonable method of allocation may be used. For example, Y uses one aircraft to provide charter services under two separate contracts. In determining whether the contracts are onerous, Y could allocate the unavoidable aircraft operating costs on a *pro rata* basis based on the relative flight hours or revenues. If the aircraft is leased and could not be sub-leased, the lease payments would not be avoidable and also should be considered when determining whether either of the charter contracts is onerous.

Benefits

The expected benefit under a contract is the net present value of the future inflows related to the contract. Estimating the future benefits to be derived may require judgement, possibly based on past experience or expert advice.

In considering the expected benefits under a contract it may be necessary to evaluate the entity's expected use of a product. For example, C manufactures chocolate and has a contract to buy cocoa beans at a cost of 7,800 per ton. The market price of cocoa beans has fallen to 7,000 per ton. The contract is not onerous unless the expected selling price of the final product (the chocolate) is less than the total cost of producing the chocolate.

IAS 39.5

As another example, assume that B, a commercial bakery, has a forward contract to purchase 100 tons of wheat at a price of 13,000 per ton. The forward contract will be settled by physical delivery of the wheat and therefore the contract is not treated as a derivative (see 3.6). At the reporting date the market price of wheat has dropped to 10,000 per ton. However, B still expects to make a profit on the sale of the bread that will be made from the wheat. Therefore, the contract is not onerous and B should not recognise a provision for the above-market price. Instead B will measure the cost of the wheat at 13,000 per ton when the risks and rewards of ownership transfer.

Leases

In our view, when assessing whether a lease is onerous, consideration should be given to any sub-lease income that could be earned. In our view, this applies even if the entity chooses not to sub-lease the asset (e.g., to avoid competitors gaining access to the area); or a sub-lease requires the lessor's approval, providing the approval cannot be reasonably withheld. However, if a lease prohibits sub-leases, then potential sub-lease income should not be considered.

Timing of recognition

Usually, a decision to terminate a contract does not result in a legal or constructive obligation. Therefore, in our view, costs of cancelling or terminating a contract should not be recognised until the contract actually is terminated, unless the contract becomes onerous.

Overall loss making operations

Some contracts may be part of an overall loss-making operation. In our view, a provision should not be recognised for these contracts unless the cash flows relating to the contract clearly are distinguishable from the operations as a whole. Otherwise, a provision effectively would be recognised for future operating losses, which is prohibited by IFRSs.

For example, T is a tour operator. Among other services, T offers cruises on a nearby lake. For this purpose, T leases a cruise ship under an operating lease. Due to increased competition for cruises, the costs of leasing the cruise ship exceed the income that T generates from its cruise operations. Given that the operating lease contract relates only to T's cruise operations, and the cash flows

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relating to these operations are separately identifiable, in our view, the lease contract should be treated as an onerous contract.

However, if T sold package tours, which included a cruise on the lake, and T's overall operations were loss making, the losses would relate to the business as a whole rather than specifically to the lease contract. In addition, it is likely that the cash inflows relating to the cruise operations would not be clearly distinguished from those relating to the other operations. Therefore, in this case we do not believe a provision for an onerous contract should be recognised. However, T must consider if the related recognised assets are impaired.

Measuring the provision

IAS 37.66 The present value of the obligation under an onerous contract should be recognised as a provision. In our view, this should be the lower of the cost of terminating the contract and the *net* cost of continuing with the contract. For example, assume an operating lease of a property is onerous. The annual lease payments are 100,000 and the property is sub-leased for an annual rental of 20,000. We believe that the provision should be measured based on the net annual cost of 80,000.

In our view, revenues directly related to the contract also should be considered in measuring the provision. For example, S, an airline has entered into an agreement under which it charters out an aircraft for 20 days for a fee of 10,000 per day. S incurs otherwise avoidable costs of 15,000 a day to operate the aircraft. The cost of operating the aircraft exceeds the revenues. Therefore, the contract is onerous and S should provide for the anticipated loss on the contract of 5,000 per day for the 20 days (i.e., 100,000 (5,000 x 20)).

We believe that the lower of the cost of fulfilling the contract and of terminating the contract should be considered in measuring the provision, regardless of the entity's intention. Extending the example of S above, if S is able to cancel the charter arrangement by paying a penalty of 40,000, a provision of 40,000 rather than 100,000 should be recognised, regardless of whether S intends to cancel the contract.

In our view, direct variable operating costs necessary to fulfil an entity's obligations under a contract that cannot be avoided should be included when measuring the provision for an onerous contract. Costs that could be avoided by the entity's future actions or that are not related directly to the contract should not be included.

If a finance lease contract is onerous, the leased asset is evaluated for impairment under IAS 36 (see 3.9). An onerous contract provision is not recognised. Although the future lease payments under the contract may exceed the carrying amount of the asset due to future finance costs, an onerous contract provision cannot be recognised for future finance costs. Any component of the future lease payments that relates to services provided under the lease should be evaluated separately to assess whether they give rise to an onerous contract.

IAS 37.69 Similarly, in our view, if a contract (including an operating lease contract) is onerous, assets dedicated to the contract (including any capitalised lease improvements) should be tested for impairment (see 3.9) before the onerous contract provision is calculated. Therefore, in the case of the airline charter contract discussed above, the fact that the operating costs exceed the revenues to be derived from the aircraft is an impairment indicator. S should test the aircraft for impairment before recognising a provision for an onerous contract.

Software modification costs

IAS 16.12 There is no present obligation to modify software even if an external event (such as the introduction of a new currency) requires the entity to make the modification. Therefore, no provision is recognised.

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Costs of modifying existing software are recognised as an expense when incurred unless they increase the expected utility of the asset and therefore qualify for capitalisation (see 3.3).

Legal claims

The obligating event for a legal claim is the event that gives rise to the claim, rather than receipt of the claim itself.

For most legal claims it is clear whether there is a past event. What may not be clear is whether an entity has an obligation as a result of the past event (e.g., the entity may not accept responsibility for the event); or whether there is a probable outflow (e.g., the entity may expect to defend the claim successfully).

In cases when an entity disputes a legal claim and legal opinion supports the view that the defence will more likely than not be successful, the legal claim gives rise to a contingent liability (see 3.13). In these cases no provision is recognised. When it is probable that the entity is liable and that there will be an outflow of resources to settle the claim, a provision should be recognised, unless the amount cannot be measured reliably. In such cases, a contingent liability would be disclosed instead.

In our view, if an entity has been unsuccessful in defending a claim, but intends to appeal the decision in a higher court, a provision should be recognised for the expected amount of the claim because, if an entity was unsuccessful in defending a claim, it cannot be argued that there is no obligation, or that an outflow is not probable.

Income tax exposures

In our view, provisions for possible income tax exposures are treated as tax liabilities, and not provisions in the scope of IAS 37 (see 3.12).

In our view, interest and penalties related to possible income tax exposures are provisions in the scope of IAS 37 as they are not based on taxable profits (see 3.12). Therefore, an entity should recognise a provision for the best estimate of interest and penalties payable relating to previous tax years, if there is a probable outflow of resources and the amount can be estimated reliably. The provision should be discounted if the effect of discounting is material.

3.11.8 Presentation and disclosure

IAS 1.61, 68 Provisions should be disclosed as a separate line item on the face of the balance sheet. Provisions that will be utilised within one year are classified as current liabilities.

Classes of provisions

IAS 37.84 Each class of provision must be disclosed separately. The extent of disaggregation that is required will depend on the significance and the nature of the individual provisions. Categories of provisions that generally should be disclosed separately include provisions for: litigation; warranties; environmental obligations; onerous contracts and restructuring costs.

Movements schedule

IAS 37.84 Movements in each class of provisions should be disclosed.

All movements must be disclosed separately on a gross basis. Amounts that are reversed or used during the period may not be netted off against additional provisions recognised during the period. For example, if the provision for litigation for some matters has increased, but for others has decreased, the gross amount of the increases and decreases is shown.

Description of provisions

IAS 37.85 Narrative information is required about the nature of provisions, the expected timing of the outflows, and uncertainties and assumptions made in measuring the provisions. The disclosure of uncertainties

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may be general in nature. For example, for a legal claim it would, in our view, be sufficient to say that the outcome depends on court proceedings#.

Forthcoming requirements

IAS 1.116 In December 2003, the IASB issued a revised version of IAS 1. The revised standard requires the disclosure of key assumptions about the future, and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see 2.4).

IAS 1.36 Comparative information should be included in the narrative information when it is relevant to an understanding of the current period's financial statements. For example, when a provision for a matter was made in a previous reporting period and was still outstanding at the beginning of the period, it may be useful to the readers to be given comparative narrative information to put the provision in its proper context.

Disclosure exemption

IAS 37.92 There is an exemption from the disclosure requirements for provisions in extremely rare cases if providing the disclosure would seriously prejudice a dispute. For example, this exception may apply to pending litigation, disputes with tax authorities and claims passing through arbitration.

The exemption applies only to the disclosures required by IAS 37, and not to disclosures that may be required by other IFRSs, for example, regarding income tax liabilities or for related party disclosures.

The exception normally would not apply in consolidated financial statements because, for example, disclosure of litigation provisions generally is made in aggregate and as such it is unlikely that the disclosure would harm the entity's position in any one case.

Presentation of onerous contract provisions

IAS 1.32 When an entity has an onerous contract, any provision recognised should be presented as a liability. It should not be netted against the carrying amount of any related assets.

Environmental and similar funds

IAS 1.32 A fund that is established to finance the costs associated with a provision should not be offset against the related provision. The provision should continue to be recognised as a liability and the interest in the fund should be treated as a separate asset (see 3.11.7).

This area of IFRSs may be subject to future developments (see 3.11.9).

Effects of discounting

IAS 37.60 The unwinding of the discount is presented as a component of interest expense.

Reversals and other changes in estimate

A reversal of a provision is a change in estimate (see 2.8). Therefore, in our view, the reversal should be presented in the same income statement line item as the original estimate. For example, changes in provisions, whether they are additional amounts (debits) or reductions in amounts previously charged (credits), should be presented in "other operating expenses" if the original estimate was recorded in that classification. However, in some instances (e.g., on the basis of the size and incidence of the change in estimate) we believe that the effect of a reversal may be presented in other operating income.

IAS 1.86(g) Reversals of provisions should be disclosed separately. Significant reversals of provisions may raise questions regarding the reliability of management estimates and should be explained in the notes (this disclosure also may be required due to the size or incidence of the reversal, see 4.1).

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Reserves for general business risks

A provision may not be recognised for costs associated with the risk of future losses. If an entity wishes to reflect risks not covered by provisions in the financial statements, in our view, it may establish a separate component of shareholders' equity (e.g., a non-distributable reserve, depending on the shareholders' approval, as may be required by the articles of incorporation or law). Amounts may be transferred to this reserve directly from retained earnings or another category of equity. Any such transfers would be disclosed as part of the movements in equity (see 3.10).

Restructuring provisions

An issue often arises as to whether restructuring costs may be presented as a separate line item in the income statement, particularly in cases where expenditures are classified according to their function. See 4.1 for guidance in this regard.

3.11.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The IASB's short-term convergence project includes work to revise IAS 37 in order to enhance convergence with FASB Statement 146 *Accounting for Costs Associated with Exit or Disposal Activities*. The IASB is expected to propose changes regarding the criteria for and timing of recognition of provisions especially for restructuring provisions. An exposure draft is expected in the third quarter of 2004.

IFRIC

IFRIC has issued draft interpretations on the following issues related to this topic:

- Accounting for emission rights (D1 *Emission Rights*). The draft interpretation proposes that the obligation to deliver allowances equal to the emissions that have been made creates a liability, which is settled by delivering allowances and / or incurring a penalty.
- Accounting for decommissioning funds (D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*). The draft interpretation proposes that unless the fund relieves the contributor of its obligation to pay decommissioning costs, it should recognise a liability and a corresponding reimbursement right. The reimbursement right should be measured at the lower of the amount of the obligation or the entity's share of the fair value of the net assets of the fund. The IASB has proposed a consequential amendment to exclude the right to reimbursement from a decommissioning fund from the scope of IAS 39.

In addition, IFRIC is considering issuing guidance on accounting for service concession arrangements and hand-back obligations.

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3.12 Deferred tax

(IAS 12, SIC–21, SIC–25)

Overview

- **Deferred tax liabilities and assets are recognised for the estimated future tax effects of temporary differences and tax loss carry-forwards.**
- **A temporary difference is the difference between the tax base of an asset or liability and its carrying amount in the financial statements.**
- **A deferred tax liability (asset) is recognised unless it arises from:**
  - **goodwill for which amortisation is not tax deductible (or negative goodwill that is treated as deferred income); or**
  - **the initial recognition of an asset or liability in a transaction that is not a business combination, and at the time of the transaction, affects neither accounting profit nor taxable profit.**
- **A deferred tax asset is recognised to the extent that it is probable that it can be utilised against future profits.**
- **The measurement of deferred tax is based on the expected manner of settlement (liability) or recovery (asset), based on rates that are enacted or substantively enacted at the balance sheet date.**
- **Deferred tax is recognised on an undiscounted basis.**
- **Deferred tax is classified as non-current in a classified balance sheet.**
- **Income tax relating to items charged or credited directly to equity is itself charged or credited directly to equity.**

Forthcoming requirements

In February 2004, the IASB issued IFRS 2 *Share-based Payment* and made consequential amendments to IAS 12 *Income Taxes*. In March 2004, the IASB issued IFRS 3 *Business Combinations* and made a number of consequential amendments to IAS 12. These consequential amendments are effective for accounting periods beginning on or after 1 January 2005. Early adoption is encouraged.

Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular:

- gains from the recognition of deferred tax assets of the acquirer as a result of a business combination are recognised in the income statement; and
- if the amount of the tax deduction (or estimated future tax deduction from a share-based payment transaction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this case the excess of the associated current or deferred tax should be recognised directly in equity.

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3.12.1 Scope

IAS 12.1, 2 The scope of IAS 12 is limited to income taxes, which are taxes based on taxable profits, as well as taxes that are payable by a subsidiary, associate or joint venture upon distribution to the investor. Taxes that are not based on taxable profits do not fall within the scope of the standard; examples include social taxes payable by an employer based on a percentage of employees' wages which are employee benefits within the scope of IAS 19 (see 4.4), and taxes payable on capital and reserves. In our view, taxes that are excluded from the scope of IAS 12 generally should be accounted for in accordance with the guidance on provisions in IAS 37 (see 3.11).

IAS 12.5 In some cases it is not clear whether a tax is based on taxable profit, which is defined in the standard as "the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)". For example, South African companies pay a secondary tax (STC) on dividends paid to shareholders; the tax is levied on the entity and is not a shareholder withholding tax. The introduction of STC in 1993 was accompanied by a reduction in the corporate income tax rate. In practice STC is treated as an income tax on the basis that it is profits that are being taxed, even though the timing of recognition of an income tax expense is linked to the payment of dividends (see 3.12.5).

In a similar example, companies in Estonia pay a tax levied on dividends paid to natural persons and non-residents, fringe benefits and certain other payments that generally are non-deductible expenses for tax purposes. However, companies pay no income tax. Similar to STC, in practice this tax is treated as an income tax.

In both examples the timing of recognising an income tax expense is linked to the payment of dividends.

The Estonian tax system is an extreme example of a dual income tax rate system, with a zero tax rate on undistributed taxable income and a higher rate on distributed income. Therefore, the income tax effect of dividends should be recognised in an entity's income statement when a liability to pay the dividend is recognised.

IAS 12.4 Also excluded from the scope of IAS 12 are government grants (see 4.3) and investment tax credits, which often are accounted for in accordance with IAS 12 by analogy (see 3.12.7).

3.12.2 Differences between carrying amounts and the tax treatment of assets and liabilities

Temporary differences

IAS 12.5 A temporary difference is the difference between the tax carrying amount (or tax base) of an asset or liability and its carrying amount in the financial statements that will result in taxable or deductible amounts in future periods when the carrying amount is recovered or settled. Therefore, in determining the amount of deferred tax to recognise under IFRSs, the analysis focuses on the balance sheet carrying amounts (a balance sheet approach) rather than on the differences between the income statement and taxable profits (an income statement approach). Temporary differences may be either taxable (will result in taxable amounts in future periods) or deductible (will result in deductions in future periods).

IAS 12.A A1 For example, entity A accrues interest of 100, which will be taxed only when it receives the cash payment. The balance sheet under IFRSs includes an asset (receivable) of 100. However, the tax balance sheet does not include an asset because the interest is not yet taxable (tax base equals zero). This difference results in a deferred tax liability (taxable temporary difference) because the amount will be taxed in a future period – when the cash is received.

IAS 12.20 In another example, entity B revalues its main production plant in accordance with the allowed alternative approach in IAS 16 (see 3.2). The tax balance sheet shows no such revaluation and the

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revaluation itself will not be taxed (tax base equals zero). This difference results in a deferred tax liability because B will use the plant to generate future economic benefits that will give rise to taxable profits, but the corresponding tax deduction will be limited to the cost of the plant. Therefore, indirectly the revaluation will be taxed and a deferred tax liability (taxable temporary difference) results.

In a further example, entity C's property, plant and equipment is revalued for tax purposes, with the revaluation surplus being deductible in future years. No revaluation is recognised under IFRSs in accordance with C's accounting policy for property, plant and equipment (see 3.2). This difference results in a deferred tax asset because C will receive future tax deductions for the additional value recognised for tax purposes. (To the extent that the tax base is increased to the same level as the carrying amount under IFRSs, this movement represents the reversal of the previously recognised taxable temporary difference rather than the origination of a deductible temporary difference.)

Book and tax basis also may differ because an entity applied cash flow hedge accounting and recognised a basis adjustment for book but not tax purposes. IAS 12 includes numerous examples of taxable and deductible temporary differences, both throughout the body of the standard and in the appendices.

Other differences

In some cases a difference arises between IFRSs and the corresponding tax treatment that is not a temporary difference because no amount will be taxable or deductible in the future. While the standard provides no definition of such items, often in practice they are referred to as "permanent" differences. This notion of "permanent" differences refers to temporary differences for which a tax value of zero is applied under IAS 12.

IAS 12.7 For example, one of entity D's investees has declared a dividend of 100 and D has recognised a receivable in its financial statements. Dividends are tax-exempt. In this case, no deferred tax liability is recognised, following either of these analyses:

- The tax base of the receivable is zero and therefore there is a temporary difference of 100; however, the tax rate that will apply is zero when the cash is received. Therefore, no deferred tax liability is recognised.
- The tax base of the receivable is 100 since, in substance, the full amount will be deductible. Therefore, no deferred tax liability is recognised.

3.12.3 Liability recognition

IAS 12.15 A deferred tax liability is recognised for all taxable temporary differences, unless the deferred tax liability arises from:

- goodwill for which amortisation is not tax deductible (see 3.12.7); or
- the initial recognition of an asset or liability in a transaction that:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting profit nor taxable profit#.

IAS 12.39 In addition, a further exemption exists in respect of investments in subsidiaries, associates and joint ventures (see 3.12.7).

Forthcoming requirements

IAS 12.15 IFRS 3 amended the exemption from the recognition of deferred tax in respect of all temporary differences related to goodwill. The revised standard requires that a deferred tax liability (asset) be recognised unless it arises from *the initial recognition of goodwill*.

In our view, the change in wording will not have any practical impact on the recognition of deferred tax, because goodwill no longer is amortised under IFRS 3.

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This area of IFRSs may be subject to future developments (see 3.12.9).

Full liability recognition

IAS 12.15 The standard requires all taxable temporary differences to be recognised as a deferred tax liability, and does not allow the partial recognition method. Therefore, it is not relevant under IFRSs that some, or all, of the differences may not be expected to crystallise in the future.

IAS 12.20 For example, entity E owns machinery with a revalued carrying amount of 150 and a tax base of 80 (original cost was 100). When the machinery is sold, any capital gain is deductible against the cost of similar replacement assets. E expects its business to grow and therefore does not expect the difference of 50 between the carrying amount and the original cost to crystallise and generate a tax liability. Nevertheless, IAS 12 requires the deferred tax liability to be recognised.

Initial recognition exemption

IAS 12.15, 22 The exemption that arises upon initial recognition is practical rather than conceptual in nature, and is one of the more difficult aspects of the standard to apply. For example, entity F acquires a building for 100. The cost of the building will never be deductible for tax purposes, even upon its eventual disposal. Therefore, the tax base is zero and a taxable temporary difference of 100 arises. In the absence of the exemption, the carrying amount of the building would be grossed up for the effect of the taxable temporary difference. However, since this was viewed as resulting in less transparent financial statements, no deferred tax liability is recognised because the transaction did not affect accounting or taxable profit at the time of the transaction. This area of IFRSs may be subject to future developments (see 3.12.9).

IAS 12.22 If the exemption applies and no deferred tax is recognised initially, no deferred tax will be recognised subsequently as the carrying amount of the asset changes. Continuing the above example, at the end of year one the carrying amount of the building is 95 after recognising depreciation. No deferred tax is recognised.

In our view, the situation would be different if the asset was revalued subsequent to initial recognition. Continuing the above example, F revalues the building at the end of year three and the new carrying amount is 120. In this case, the revaluation is a new transaction for the purpose of applying IAS 12, and a deferred tax liability should be recognised based on the excess of the revaluation over original cost (20 in this example). For the recognition of deferred tax in respect of asset revaluations see 3.12.2.

Partial deductions

In some cases the cost of an asset is only partially deductible for tax purposes. For example, entity G acquires machinery for 200. For tax purposes, 80 per cent of the cost can be deducted; the remaining 20 per cent can never be deducted, even upon disposal.

In our view, the asset should be split into two components for the purpose of calculating deferred tax:

- The initial recognition exemption applies to a cost of 40 (200 x 20 per cent). Therefore, no deferred tax will be recorded on initial recognition or as this portion of the asset is depreciated subsequently.
- The general requirements should apply to a cost of 160 (200 x 80 per cent). This means that no deferred tax will be recognised initially because the carrying amount and tax base of the asset are both 160. However, if a temporary difference arises as the asset is depreciated, deferred tax should be recognised.

Finance leases

The treatment of finance leases in relation to the initial recognition exemption is particularly difficult, depending on the treatment allowed by the tax authorities. The following example illustrates this issue.

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Tax deduction for lease payments

Entity H enters into a finance lease and records an asset and a corresponding liability on its balance sheet. For tax purposes the lease payments, which are not spread evenly over the lease term, are deductible on a cash basis. Although there is an asset under IFRSs, there is no corresponding asset for tax purposes and therefore, a temporary difference arises on the initial recognition of the asset. Similarly, there is a liability recognised under IFRSs that has a tax base of zero and therefore, a temporary difference arises on the initial recognition of the liability. Also, the transaction does not affect either accounting or taxable profit upon initial recognition. Therefore, under one interpretation of the initial recognition exemption, deferred tax would not be recognised in respect of the asset or the liability, either initially or as the asset is depreciated and the liability is repaid. This would give rise to the following accounting:

	Debit	*Credit*
Property, plant and equipment	100	
Lease liability		100
Initial recognition of finance lease		
Income statement (depreciation)	10	
Property, plant and equipment		10
Depreciation in respect of year one		
Income statement (interest expense)	8	
Lease liability	12	
Cash		20
Lease repayment in respect of year one		

Under the "no recognition" interpretation at the end of year one no deferred tax liability would be recognised under the initial recognition exemption, even though H will generate future economic benefits of 90 (100 - 10) through use of the asset, but will be entitled to deductions of only 88 (100 - 12), thus creating a taxable temporary difference of two. In our view, the non-recognition of this taxable temporary difference is not an appropriate application of the exemption. We believe that the asset and liability that arise for accounting purposes under a finance lease are integrally linked, and should be regarded as a net package (the finance lease) for the purpose of recognising deferred tax. This is consistent with how a lease transaction is viewed for tax purposes. In our view, the above example should be analysed as follows:

- Upon initial recognition of the transaction, a taxable temporary difference of 100 arises on the asset, and a deductible temporary difference of 100 arises on the liability, giving a net temporary difference of zero. Therefore, no deferred tax is recognised. The initial recognition exemption does not apply because there is no temporary difference.
- At the end of year one, a taxable temporary difference of 90 exists on the asset, and a deductible temporary difference of 88 exists on the liability, giving a net taxable temporary difference of two in respect of which deferred tax should be recognised.

Decommissioning provisions

Another area of difficulty in relation to the initial recognition exemption is the treatment of decommissioning provisions that are capitalised as part of the cost of property, plant and equipment (see 3.2). For example, entity K recognises a provision for site restoration, which is capitalised; for tax purposes the expenditure will be deducted only when incurred and therefore the tax base of the liability is zero. This deductible temporary difference arises on initial recognition of the provision, but does not affect either accounting or taxable profit. Therefore, under one interpretation of the initial recognition exemption deferred tax would not be recognised in respect of

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the provision, either initially or as the asset is depreciated. This would give rise to the following accounting:

	Debit	Credit
Property, plant and equipment	100	
Provision		100
Initial recognition of provision		
Income statement (depreciation)	10	
Property, plant and equipment		10
Depreciation in respect of year one		

Under the "no recognition" interpretation at the end of year one no deferred tax liability would be recognised under the initial recognition exemption even though K will generate future economic benefits of 90 (100 - 10) through use of the asset, but will be entitled to deductions of 100, thus creating a deductible temporary difference of 10. In our view, the non-recognition of this deductible temporary difference is not an appropriate application of the exemption. Consistent with our analysis for finance leases (see above), in our view the asset and liability that arise in accounting for a decommissioning provision are integrally linked, and should be regarded as a net package for the purpose of recognising deferred tax.

Compound financial instruments

IAS 12.23, 62(d), 12.A A9, 12.B4

A difference in classification between IFRSs and the tax balance sheet does not trigger the initial recognition exemption. The example given in the standard is a compound financial instrument that has both a liability and an equity component. For example, entity L issues convertible debt for proceeds of 100; in accordance with IAS 32 (see 5.6) a liability of 80 is recognised and the remaining 20 is recognised as equity. For tax purposes, the carrying amount of the liability is 100. The temporary difference arises from a difference in the classification of the instrument rather than from a difference in the initial recognition – the total carrying amount in both cases is 100. Therefore, the initial recognition exemption does not apply and deferred tax in respect of the taxable temporary difference of 20 is recognised in equity.

The same principle would apply when an entity has received a low-interest loan from a shareholder. For example, entity M receives a loan of 100 from its parent; no interest is payable on the loan. In accordance with IAS 39 (see 3.6), M recognises a liability of 70 and a capital contribution of 30. For tax purposes the carrying amount of the loan is 100. Once again the temporary difference arises from a difference in initial classification rather than from a difference in recognition and therefore a taxable temporary difference of 30 is recognised.

The above analysis would be different if the tax authorities allowed the entity to claim a full deduction for the imputed discount on the liability component of the convertible bond. In this case, there would be no temporary difference at the date of initial recognition and the initial recognition exemption would not apply. This means that if a temporary difference arises subsequent to initial recognition, the resulting deferred tax should be recognised.

Transfer of assets

The initial recognition exemption applies to transactions that are *not* business combinations. Therefore, we believe that if a transaction that is not a business combination is accounted for using uniting of interests accounting, either directly or by analogy, the initial recognition exemption applies and temporary differences that arise, either initially or subsequent to initial recognition, should not be recognised as long as they relate to the initial recognition of the related assets and liabilities.

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However, if in substance the transfer of assets results in a change in tax status, then the requirements of SIC–25 should be applied (see 3.12.6).

3.12.4 Asset recognition

IAS 12.24 Unlike deferred tax liabilities, a deferred tax asset is recognised in respect of deductible temporary differences only to the extent that it is *probable* that taxable profit will be available against which the deductible temporary differences can be utilised. However, similar to deferred tax liabilities, no deferred tax asset is recognised if it arises from:

- negative goodwill that is treated as deferred income in accordance with IFRSs (see 3.12.7); or
- the initial recognition of an asset or liability in a transaction that:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting profit nor taxable profit#.

IAS 12.A B7 The issues that arise in respect of the initial recognition exemption for deferred tax assets are similar to those in respect of deferred tax liabilities (see 3.12.3). In particular, no deferred tax asset is recognised in respect of non-taxable government grants, whether deducted from the cost of the asset or presented as deferred income for IFRSs purposes (see 4.3), since the temporary difference arises at the time of the transaction and affects neither accounting nor taxable profit.

IAS 12.44 Also, similar to deferred tax liabilities, a further exemption exists in respect of investments in subsidiaries, associates and joint ventures (see 3.12.7).

Forthcoming requirements

IAS 12.15 IFRS 3 amended the exemption from the recognition of deferred tax in respect of all temporary differences related to goodwill. The revised standard requires that a deferred tax asset (liability) is recognised unless it arises from *the initial recognition of goodwill*.

In our view, the change of wording will not have any practical impact on the recognition of deferred tax, because goodwill no longer is amortised under IFRS 3.

This area of IFRSs may be subject to future developments (see 3.12.9).

IAS 12.24 Although an entity is required to consider the probability of realising the benefit of deductible temporary differences, "probable" is not defined in the standard. In practice entities often use a working definition of "more likely than not", which is consistent with the definition of probable in respect of provisions (see 3.11). However, the standard does not preclude a higher threshold from being used. In our view, a single definition of "probable" should be developed and applied throughout a group for the purpose of recognising deferred tax assets (e.g., more likely than not, or more than 60 per cent likely). However, in our view, a threshold approaching 95 per cent could not be used, as that would be more consistent with the "virtually certain" test for contingent assets (see 3.13).

IAS 12.28, 29 In considering whether taxable profit will be available in the future, an entity considers:

- taxable temporary differences that will reverse (i.e., will become taxable) in the same period that deductible temporary differences reverse (i.e., will become deductible);
- the periods into which a tax loss arising from a deductible temporary difference can be carried back or forward;
- the probability of generating taxable profits in the periods that the deductible temporary differences reverse; and
- tax planning opportunities.

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Taxable temporary differences

IAS 12.28 In considering the availability of taxable temporary differences in order to recognise a deferred tax asset, it is necessary to estimate the periods in which the reversals are expected to occur. For example, entity N has a possible deferred tax asset of 100 in respect of a liability for employee benefits. For tax purposes the expenditure is deducted as incurred, which is expected to be in two years' time. N also has a deferred tax liability of 300 in respect of property, plant and equipment, of which 150 is expected to reverse in two years' time and the remaining 150 in four years' time. Therefore, N can recognise the deferred tax asset on the basis that the reversing deferred tax liability will generate sufficient taxable profit to enable the deferred tax asset to be utilised.

IAS 12.8-29 Changing the facts in the above example, the employee benefit expenditure is expected to be incurred in 10 years' time and there are no existing taxable temporary differences that are expected to reverse in the same period. However, N expects to continue investing in property, plant and equipment and fully expects that future taxable temporary differences, sufficient to absorb the deductible temporary difference, will be available 10 years from now. In this case the standard is specific that taxable temporary differences expected to arise in the future cannot be taken into account because the deductions associated with such differences (deduction of tax depreciation) also require taxable profit in order to be utilised. Therefore, N would not be able to recognise a deferred tax asset (subject to an analysis of other sources of taxable profit).

In some cases it is not clear when a deductible temporary difference reverses. For example, entity O is a retailer that recognises an allowance for doubtful debts. For tax purposes the allowance cannot be deducted; instead, actual bad debts are deducted in accordance with criteria established by the tax authorities. Since the allowance for doubtful debts remains constant or grows slightly year on year, O believes that the deductible temporary difference will never reverse as long as it remains in business. In our view, the allowance reverses each year and is replaced by a new allowance against new trade receivables. Therefore, in assessing whether a deferred tax asset should be recognised, we would consider its recoverability in the following year.

Future taxable profits

In our view, the assessment of whether a deferred tax asset should be recognised on the basis of the availability of future profits should take into account all factors concerning the entity's expected future profitability, both favourable and unfavourable. If an entity has a stable earnings history, there is no evidence to suggest that current earnings levels will not continue into the future, and there is no evidence to suggest that the tax benefits will not be realised for some other reason, then in our view, a deferred tax asset should be recognised.

For example, entity P has a deductible temporary difference in respect of a liability for employee benefits, the majority of which is expected to reverse in 20 years' time. P has a history of being profitable and there is no reason to believe that it will not be profitable in the future; however, P prepares budgets and forecasts for a period of only two years into the future. In our view, a deferred tax asset should be recognised notwithstanding the limited period for which budgets and forecasts are available.

In another example, entity Q is a wine maker and the land from which it operates is vital to its operations. The land is revalued for tax purposes (but not under IFRSs) and the revaluation surplus is deductible from the sales proceeds when the land is sold. Therefore, the revaluation creates a deductible temporary difference that will reverse when the land is sold (see 3.12.2). However, Q needs to maintain possession of the land on which the grapes are grown in order to continue its business of producing wine; therefore, it is not possible to forecast when or if the land will be disposed of. In our view, the difficulty of estimating the timing of the reversal of the temporary difference is not in itself a reason for not recognising a deferred tax asset, but it is a factor that is relevant in assessing the probability of the availability of future tax benefits. If the fair value of the land is equal to or higher than its revalued tax base, in our view, it is probable that a taxable profit will

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be available to offset the deductible temporary difference. For example, if the carrying amount of the land is 60, but its estimated fair value is 100 and the revalued tax base is 70, taxable profit of 30 would be generated upon sale; in that case, a deferred tax asset should be recognised for the deductible temporary difference of 10 (70 - 60).

An assessment of future taxable profits would be different when the deferred tax asset arises from tax losses (see below).

Tax planning opportunities

IAS 12.30 Tax planning opportunities are defined as "actions that an entity would take in order to create or increase taxable income for a specific period in order to utilise an expiring tax loss or tax credit carry-forward". An example includes deferring the claim for certain deductions from taxable profits to a later period. However, these opportunities do not include creating taxable profit in the future from future originating temporary differences.

In our view, it should be management's intention to take advantage of these opportunities, or at least it is more likely than not that they will take advantage of these opportunities, before they can be used to justify the recognition of deferred tax assets. In most cases, it can be presumed that the entity will take advantage of any opportunity to reduce its overall tax burden. However, when taking advantage of the opportunities involves, for example, making an irrevocable election which may have other, disadvantageous, implications for the future, thought should be given as to whether management actually believes it is probable that they will make the election.

Unused tax losses and tax credits

IAS 12.34-36 The sources of taxable profit discussed above in respect of deductible temporary differences apply equally in assessing whether a deferred tax asset arising from unused tax losses and unused tax credits may be recognised. However, the standard does provide some further guidance in this area, as highlighted below.

- When an entity has a history of recent losses, a deferred tax asset is recognised only to the extent that the entity has sufficient taxable temporary differences or there is convincing evidence that sufficient taxable profit will be available against which the tax losses or tax credits can be utilised.
- An entity should consider whether any unused tax losses arise from identifiable causes that are unlikely to recur; if so, this makes it easier to justify recognition of the resulting deferred tax asset.

For example, entity T was established one year ago and is in its "start-up" phase. In its first year of operations T has a loss of 500 for tax purposes. T expects to be profitable by its third year of operations, and expects all tax losses to be utilised by the end of its fifth year of operations. In our view, T should not recognise a deferred tax asset in respect of the tax losses because we believe that it is not appropriate to forecast profits when a business is in a start-up phase, unless there is convincing evidence that future taxable profits will be available (e.g., signed contracts are in place and it is clear that the business can operate at a cost level that will result in taxable profits).

IAS 12.82 When an entity has suffered a tax loss in the current or preceding period in a tax jurisdiction in respect of which a deferred tax asset has been recognised in the financial statements, both the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed.

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3.12.5 Measurement

IAS 12.47, 51

Deferred tax assets and liabilities are measured based on:

- the expected manner of recovery (asset) or settlement (liability); and
- the rate of tax expected to apply when the underlying asset (liability) is recovered (settled), based on rates that are enacted or substantively enacted at the balance sheet date.

In our view, the rate of tax expected to apply is based on the statutory tax rate and not an entity's effective tax rate. For example, entity U is subject to a statutory tax rate of 30 per cent; however, after tax deductions it usually pays tax of around 20 per cent. We believe that deferred tax should be recognised using the tax rate of 30 per cent and U should not anticipate future deductions.

The expected manner of recovery or settlement

IAS 12.52

In some tax jurisdictions the applicable tax rate depends on how the carrying amount of an asset or liability is recovered or settled. In such cases management's intentions are key in determining the amount of deferred tax to recognise. For example, entity V owns an operating plant that it intends to continue using in its operations. If the plant was sold, any gain would attract capital gains tax of 20 per cent; the income tax rate is 30 per cent. In this case deferred tax is measured using a rate of 30 per cent because the carrying amount will be recovered through use its ongoing operations. Even if the plant is revalued, deferred tax would be measured at a rate of 30 per cent because as the plant is recovered through operations and taxable operating income is generated, it will be taxed at a rate of 30 per cent.

Dual intention

In many cases an entity will have a dual intention with respect to assets (i.e., to operate the asset and then to sell it before the end of its useful life). In that case the carrying amount will be recovered in two ways and the calculation of deferred tax should reflect that dual intention.

For example, entity W pays 1,000 for a building that has an economic life of 20 years. W plans to use the building for 10 years and then sell it; W has estimated that the residual value will be 600 at the end of year 10. For tax purposes the cost of the building will be deducted over 10 years. If the building is ever sold, any recovery of the original cost will be taxed at the income tax rate of 40 per cent; the proceeds in excess of original cost will be taxed at 10 per cent.

At the end of the first year the building's carrying amount is as follows:

	Book	*Tax*
Cost	1,000	1,000
Residual value	(600)	-
Depreciable amount	400	1,000
Depreciation for year 1	40	100
Carrying amount at the end of year 1	960	900

In this case, W would recognise the entire deferred tax liability in respect of the building at 40 per cent because:

- to the extent the carrying amount of the building is recovered through use (960 - 600), a tax rate of 40 per cent will apply; and
- to the extent the building is sold and the residual value of 600 is recovered, a tax rate of 40 per cent will apply because 600 is below the original cost of 1,000.

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Continuing the above example, W revalues the building at the end of the first year. The revised carrying amount of the building is 1,500, with a revised residual value of 1,200. The carrying amount of the building for tax purposes is 900. In our view, deferred tax should be recognised as follows:

- The total taxable temporary difference is 600 (1,500 - 900).
- When the building is disposed of, estimated proceeds of 1,200 will be received, and the amount of the temporary difference up to the difference between the original cost of the building and its tax basis (i.e., 100 (1,000 - 900)) will be taxed at 40 per cent because it represents a recovery of the deductions allowed previously.
- The amount of the temporary difference for the difference between the revised residual value and original cost (i.e., 200 (1,200 - 1,000)) will be taxed at 10 per cent because it represents proceeds in excess of the original cost.
- The carrying amount of the building in excess of the revised residual value (i.e., 300 (1,500 - 1,200)) is expected to be recovered through use (i.e., assessable income will be generated that will be taxed at 40 per cent).
- Therefore, a deferred tax liability of 180 would be recognised:
  - 100 x 40% = 40; plus
  - 200 x 10% = 20; plus
  - 300 x 40% = 120.

Non-depreciable property, plant and equipment

In a further example, entity X owns a piece of land that is not depreciated. For tax purposes, the cost of the land is 300 and it is depreciated over 15 years. At the end of 2004 the carrying amount of the land under IFRSs is 300, and the carrying amount for tax purposes is 150. X revalues the land to 400 in accordance with the allowed alternative for property, plant and equipment (see 3.2); the revaluation is not recognised for tax purposes. If the land ever is sold any recovery of the original cost will be taxed at the income tax rate of 30 per cent; the proceeds in excess of the original cost will not be taxed.

SIC 21.5 When a non-depreciable item of property, plant and equipment is revalued, the deferred tax on the revaluation must be measured using the tax rate that would apply upon disposal. Therefore, the deferred tax calculations are as follows:

- Prior to the revaluation X has recognised a deferred tax liability of 45 (150 x 30 per cent).
- As a result of the revaluation X will not recognise any further deferred tax liability because there will never be any taxation consequences arising from the revaluation above original cost.

Investment property

SIC 21.4 The requirements in respect of the revaluation of non-depreciable assets apply also to investment property that is accounted for at fair value and that would be considered non-depreciable *if* they fell within the scope of IAS 16 (see 3.2). The implications of this are as follows:

- If an investment property comprises a building only, deferred tax should be recognised on changes in fair value that are recognised because a building would be depreciated under IAS 16 (see 3.4). The amount of deferred tax recognised should be based on the manner in which the carrying amount of the building is expected to be recovered (see above).
- If an investment property comprises land only, and assuming that the land would not be depreciated under IAS 16, deferred tax should be recognised based on the consequences of the disposal of that land.
- If a single investment property comprises land and buildings, the valuation should be split into its component parts in order to determine the amount of deferred tax. In some cases this may result in additional valuation work being required in order to determine that split.

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For example, entity Y acquired an investment property that comprises a beachfront plot of land with a two-star hotel. The cost of the investment property was 600, which Y split 540 for the land and 60 for the building. For tax purposes the property, including land, is depreciated over 20 years. A year later Y employs an independent valuer in order to establish the fair value of the property; the valuer concludes that the fair value is 700. The income tax rate in Y's jurisdiction is 35 per cent; there is no capital gains tax. In order to calculate deferred tax, Y asks the valuer to provide information about the respective fair values of the land and building components. The valuer reports that the land component is 650 and the hotel component is 50. Therefore, upon revaluing the property Y recognises deferred tax as follows:

- The building has a carrying amount of 50 under IFRSs and a tax carrying amount of 57 (60 - 3 for depreciation in year one). Therefore, a deferred tax asset of two (7 x 35 per cent) arises at the end of year one.
- The land has a carrying amount of 650 under IFRSs and a tax carrying amount of 513 (540 - 27 for depreciation in year one). Since there is no capital gains tax, at the end of year one the taxable temporary difference is limited to the difference between the original cost and the tax carrying amount (i.e., 27 (540 - 513)), and a deferred tax liability of nine (27 x 35 per cent) arises.
- Therefore, the net deferred tax liability is seven.

Corporate structure

In some cases single assets (e.g., a building) are held within a corporate structure for tax planning reasons. In such cases, it might be tax-efficient for the entity to dispose of the shares in the entity rather than disposing of the underlying asset. In our view, the recognition of deferred tax in such cases should be based upon the extent to which management intends to:

- dispose of the shares (rather than the underlying asset); and / or
- use the asset in its operations.

Financial assets

For financial assets that are held for trading and available-for-sale, in our view it should be assumed that the carrying amount of the asset will be recovered through sale unless, in the case of assets classified as available-for-sale, management has a clear intention that the recovery of the carrying amount will be through the receipt of dividends and the repayment of capital. When there is a dual intention with respect to the recovery of the carrying amount, a more detailed analysis will be required following the same methodology as illustrated above under *Dual intention*.

When the financial asset is an investment in a subsidiary, associate or jointly controlled entity, special recognition criteria apply to determine whether any deferred tax should be recognised (see 3.12.7).

Split tax rates

IAS 12.49

When different statutory tax rates apply to different levels of taxable income, it is necessary to determine the average statutory rate that is expected to apply when the temporary difference reverses. For example, entity A pays tax at 20 per cent on the first two million of taxable profit in any year, and 30 per cent on taxable profit in excess of two million. In our view, it is necessary to prepare forecasts in order to estimate the tax rate that will apply when temporary differences reverse; in each period the forecast should be updated and the balance of deferred tax should be revised as a change in estimate (see 2.8), if necessary.

We believe that the above example is different from using an effective tax rate to recognise deferred tax (see above) because in this case the statutory rate varies depending on the level of taxable income – not depending on what tax deductions are available.

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In another example, in country B profits realised in the local market are taxed at 20 per cent, whereas profits from exports are taxed at 10 per cent; deductions in respect of capital assets used to support the business in both markets (e.g., property, plant and equipment) are taxed at a weighted average rate based on the proportion of profits earned in each market. Similar to the previous example, in our view, it is necessary to prepare forecasts, which should be updated at each balance sheet date, in order to estimate the tax rate that will apply when temporary differences associated with both markets reverse.

Enacted or substantively enacted

IAS 12.47, 48

In most cases the calculation of deferred tax will be based on tax rates that have been enacted. However, in some jurisdictions it may be clear that a change in tax rate is going to be enacted even though the legal process necessary in order to effect the change has not yet been completed.

For example, the president of country Z indicated to the public in July 2004 that she would like to reduce the corporate tax rate from 40 to 30 per cent. The issue was debated by the government in August and September, and on 30 November the government announced formally that the reduction in tax rate would take effect in January 2005. However, the change in tax rate was not written into law until a presidential decree confirming the change in law was signed in February 2005. In country Z, the signing of a presidential decree is a mere formality and the president cannot override decisions announced formally by the government. Therefore, in our view, the tax rate of 30 per cent is substantively enacted on 30 November and should be used in the calculation of deferred tax from that date.

IAS 10.22

If the example had been different and the president of country Z had the power to override or veto decisions made by the government, in our view, the new tax rate of 30 per cent should not be used until enacted in February 2005. However, if the new tax rate is enacted prior to authorisation of the financial statements, the notes should include disclosure of this non-adjusting event (see 2.9).

In some countries, entities are able to negotiate a rate of tax with the government that is different from the general statutory rate. In our view, the negotiated rate should not be used in the determination of deferred tax until a formal agreement is in place confirming that rate. This is because the negotiated rate is not "enacted" or "substantively enacted" for that particular entity until agreement has been reached with the government.

Tax holidays

IAS 12.47

Some countries provide tax holidays (i.e., periods in which no tax is payable) for entities in a start-up phase or which meet certain investment criteria. In our view, it is not appropriate to base the recognition of deferred tax on the tax rate that applies when a temporary difference originates; instead, we believe that the entity should consider the rate of tax expected to apply when the underlying asset (liability) is recovered (settled).

For example, entity C has a two-year tax holiday; from the third year a tax rate of 33 per cent applies. At the start of the tax holiday C purchased a machine for 100 that will be operated, and therefore depreciated, over its estimated useful life of five years under IFRSs; for tax purposes the machine is depreciated over four years. In this example the temporary difference originates during the tax holiday in years one and two, and reverses only in year five.

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Therefore, in our view, that deferred tax should be provided during the tax holiday, as shown in the following table.

End of year	*Asset balance*		*Temporary*	*Deferred tax*	*Deferred tax*
	Book	*Tax*	*difference*	*balance*	*movement*
1	80	75	(5)	(2)	(2)
2	60	50	(10)	(3)	(1)
3	40	25	(15)	(5)	(2)
4	20	-	(20)	(7)	(2)
5	-	-	-	-	7

Tax rate dependent upon profit distribution

IAS 12.52A, B

When income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is distributed, deferred tax is based on the tax rate applicable to undistributed profits. When a liability for the payment of dividends is recognised in the financial statements, the tax consequences of the distribution also are recognised.

Tax-exempt reserves

In some countries, the tax authorities allow gains on the disposal of property, plant and equipment to be added to a tax-exempt reserve that is taxed only when the reserve is distributed in the form of dividends or upon liquidation.

For example, in country E any capital gain on the disposal of certain machines is not taxable, provided that the capital gain is not distributed and is recorded in a "reserve not available for distribution". If the capital gain is distributed, it is taxed at the income tax rate of 40 per cent. An entity in country E sells a machine with a carrying amount of 250 for 350, earning a gain on disposal of 100. For tax purposes, the 100 gain on disposal will be taxed in future periods only if distributed. The deferred tax on this taxable temporary difference should be calculated at the income tax rate for undistributed earnings, which is zero in this case; therefore, no deferred tax liability is recognised (100 x 0 per cent). Income tax payable of 40 (100 x 40 per cent) is recognised only when a liability to distribute the reserve is recognised.

In some countries the tax authorities allow revaluations for tax purposes, whereby part of the tax revaluation is recorded in a tax-exempt reserve, which will be taxed only upon distribution of dividends out of this tax-exempt reserve. The issue is whether a deferred tax asset should be recorded in the period in which the tax revaluation takes place.

For example, in country F entities may revalue property, plant and equipment for tax purposes, and subsequent depreciation based on the revalued amount is tax deductible at the income tax rate of 40 per cent. The revaluation is taxed immediately at 25 per cent and credited to a revaluation reserve in equity (for tax purposes). Upon distribution of the revaluation reserve further income tax is payable at a rate of 15 per cent (the normal income tax rate of 40 per cent less the 25 per cent tax already paid). The revaluation is not recorded under IFRSs.

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Assuming that the carrying amount under IFRSs equaled the tax base prior to a revaluation of 100, the accounting entries are:

	Debit	*Credit*
Income statement (income tax)	25	
Income tax payable		25
Recognition of current tax (100 x 25 per cent)		
Deferred tax asset	40	
Income statement (income tax)		40
Recognition of deferred tax asset (100 x 40 per cent)		

No deferred tax liability is recognised for the portion of the revaluation reserve that is tax-exempt until the related dividend is recognised. The recognition of the deferred tax in this example in the income statement is discussed in 3.12.6.

Recognition of deferred tax assets

In some cases tax regulations in respect of distributions to shareholders have a direct effect on the recoverability of deferred tax assets. For example, in country G tax is payable on dividends to shareholders to the extent that the underlying profits were not subject to income tax. The following example compares the positions of two entities, G1 and G2:

	G1	*G2*
Taxable income before tax losses	1,000	1,000
Unused tax losses from previous year	-	(1,000)
Taxable income	1,000	-
Income tax at 30%	300	-
Dividend to shareholders	700	700
Tax related to dividend (300/700 x 700)	300	300
Less income tax already paid	(300)	-
Additional tax payable	-	300

Although G2 was able to deduct tax losses in determining income tax payable, by paying a dividend to its shareholders it lost the benefit of those tax losses. Therefore, a question arises as to whether G2 should recognise a deferred tax asset when dividend payments are planned.

IAS 12.52A, B

Although the tax consequences of distributions to shareholders should not be recognised until the distribution itself is recognised, in our view an entity should not recognise a deferred tax asset if it knows that the benefit will not be recovered in the future either, because a dividend has been declared, or because the entity has a specific dividend policy (e.g., a third of all profits are declared as a dividend).

Discounting

IAS 12.53

Deferred tax amounts may not be discounted. Instead, the nominal amount is presented in the balance sheet even if the effect of discounting would be material.

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3.12.6 Classification and presentation

Where to recognise deferred tax

IAS 12.58 Deferred tax recognised as part of a business combination that is an acquisition is adjusted against goodwill or negative goodwill upon initial recognition (see 3.12.7). In other cases deferred tax is recognised in the income statement, except to the extent that it relates to items charged, in the current or previous period, directly to equity#.

There is no explicit guidance under IFRSs as to the reserve in equity in which deferred tax should be recognised. In practice deferred tax generally is recognised in the same reserve as the underlying item to which it relates. For example, deferred tax relating to a revaluation of property, plant and equipment usually is recognised in the revaluation reserve. In our view, this is the preferred approach, but an entity also may recognise the deferred tax directly in retained earnings or in some other reserve.

Forthcoming requirements

IAS 12.68A-C IFRS 2 made consequential amendments to IAS 12 to provide guidance on accounting for the tax effects of share-based payments. The revised standard specifies that if the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this case the excess of the associated current or deferred tax should be recognised directly in equity.

IAS 12.66-68 IFRS 3 also amended IAS 12 to introduce a major change to the recognition of the effect of a business combination on deferred tax recognised by the acquirer. For example, an acquirer may consider it probable that it will be able to utilise its previously unrecognised tax losses against the future taxable profit of the acquired entity. In such cases, the amended standard requires the acquirer to recognise the deferred tax asset as a gain in the income statement rather than against goodwill (as previously required).

Revaluations

IAS 12.62, 64 Whether or not the deferred tax relating to a revaluation is recognised in the income statement or in equity depends on the treatment of the revaluation under IFRSs. For example, entity H revalues property, plant and equipment and recognises the revaluation in equity in accordance with the revaluation model (see 3.2); in this case the related deferred tax also is recognised in equity.

In the above example, subsequent changes in the temporary difference that arise as the asset is depreciated are recognised in the income statement and the balance in the revaluation reserve is not adjusted. However, in the case of property, plant and equipment, an entity is permitted but not required to make transfers from the revaluation reserve to retained earnings as the revaluation is realised (e.g., through depreciation); in such cases any transfer would be made net of the related deferred tax (see 3.2).

IAS 12.65 The situation is different when the revaluation is carried out for tax rather than for accounting purposes (e.g., when the tax authorities permit or require adjusting the tax base of property, plant and equipment). In such cases, the change in deferred tax is recognised in the income statement unless the tax revaluation is linked to an accounting revaluation, either in the past or in a future period, that was (or will be) recognised directly in equity.

Transactions involving an entity's own shares

Since transactions involving an entity's own shares (e.g., the purchase and reissue of treasury shares) are recognised in equity, the resulting deferred tax is recognised in equity also. For example, entity J issues shares and incurs transaction costs of 100, which are deductible for tax purposes (the tax rate is 30 per cent). However, J has tax losses and the deduction cannot be utilised in the current year. J has determined that it is probable that the tax losses will be utilised before they expire (see 3.12.4), and accordingly the deferred tax asset is recognised in full.

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Therefore, the credit for the amount of the deferred tax asset relating to the transaction costs (30) should be recognised directly in equity.

IAS 12.63 Changing the facts of the example, J has total tax losses of 150, which includes the 30 in respect of the transaction costs. After considering the probability of utilising the tax losses before they expire, J concludes that an asset for only 50 per cent of the losses should be recognised. In this case it is very difficult to attribute the part of the tax loss recognised to specific items, and the standard allows a reasonable allocation between the income statement and equity to be made. In this example, it would be reasonable to conclude that 50 per cent of tax attributable to the transaction costs are recoverable and therefore that 15 (100 x 50 per cent x 30 per cent) should be recognised in equity.

IAS 12.61 The requirement to recognise in equity the tax effect of items recognised in equity extends beyond the initial recognition of a deferred tax liability (or asset) to any subsequent revisions to the tax balance. If, in the following year, J revises its estimate and concludes that the full deferred tax asset should be recognised, the additional 15 relating to the transaction costs would be recognised in equity also.

Continuing the above example, when the transaction costs actually are deducted for tax purposes, a current tax asset will arise, which will be offset by the reversal of the deferred tax asset. In our view, both the current tax and the related deferred tax reversal should be recognised in equity, resulting in a net effect of zero on equity.

In a different example, entity K acquires its own shares for 100 for the purpose of using them as consideration in acquiring a subsidiary at a later date; at the balance sheet date the fair value of the shares has increased to 120. When the shares are disposed of K will be taxed on the difference between the cost of the shares and their fair value. Since K's intention is to dispose of the shares, a taxable temporary difference of 20 arises. In our view, this deferred tax amount should be recognised in equity since the underlying item (i.e., the share transaction) was recognised in equity.

Income taxes triggered by the payment of dividends

IAS 12.52B Income taxes that are linked to the payment of dividends (see 3.12.5) generally are linked more directly with past transactions and events than with the actual distribution to shareholders. Therefore, the classification between the income statement and equity follows the same general principles as outlined above.

For example, entity L is subject to income tax of 20 per cent, but pays a further 10 per cent when earnings are distributed. L has two temporary differences: a deductible temporary difference of 120 relating to its allowance for doubtful debts; and a taxable temporary difference of 420 relating to the revaluation of property, plant and equipment, which was recognised directly in equity. In the current year L declared dividends for the first time, amounting to a third of its total accumulated earnings. L will recognise the additional deferred tax as follows:

- A benefit of four relating to the allowance for doubtful debts will be recognised in the income statement (120 x $^1/_3$ x 10 per cent).
- An expense of 14 relating to the revaluation of property, plant and equipment will be recognised directly in equity (420 x $^1/_3$ x 10 per cent).

Dividend withholding tax

IAS 12.65A In some countries a dividend withholding tax is payable on distributions to shareholders. Such taxes are not attributable to the entity paying the dividend; rather, they are collected by the entity and paid to the tax authorities on behalf of the shareholder. Therefore, such taxes are recognised in equity as part of the distribution to shareholders. For example, entity M declares a dividend of 200, 20 per cent of which is payable to the tax authorities.

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M will record the following journal entry:

	Debit	Credit
Equity (distribution)	200	
Liability (to shareholders)		160
Liability (to the tax authorities)		40

Change in tax status

SIC 25.4 The recognition of changes in deferred tax caused by a change in the tax status of an entity or its shareholders follows the general principles outlined above. The change in deferred tax is recognised in the income statement except to the extent that it relates to an item (e.g., a revaluation of property, plant and equipment) recognised directly in equity in the current or in a previous period.

Privatisation

SIC 25.4 In our view, a privatisation that involves the creation of a new entity, but which is accounted for as a common control transaction using book values (see 2.6), is not a business combination as envisaged in the initial recognition exemption in IAS 12 (see 3.12.3). In addition, in our view any temporary differences that arise from a privatisation accounted for using book values are similar to temporary differences that arise from a change in tax status (see above). Therefore, in our view, deferred tax should be recognised in the income statement except to the extent that it relates to an item recognised directly in equity in the current or in a previous period.

IAS 1.68, 70 For example, government N privatises its electricity network by forming a new entity O into which all assets and liabilities relating to its electricity network are transferred. Subsequent to the transfer the shares in O are sold to new owners in the private sector. Under IFRSs the assets and liabilities are transferred at book value; however, new tax bases are set by the tax authorities at the date of the transaction, which gives rise to additional temporary differences. In our view, the additional deferred tax should be recognised in the income statement of entity O.

Classification in the balance sheet

IAS 1.68, 70 Deferred tax liabilities and assets always should be classified as non-current when a classified balance sheet is presented (see 3.1), even though it may be expected that some part of the deferred tax balance will reverse within 12 months of the balance sheet date. In addition, deferred tax liabilities and assets should be presented separately from current tax liabilities and assets.

Offset

IAS 12.74 Deferred tax liabilities and assets must be offset if the entity has a legally enforceable right to offset current tax liabilities and assets, and the deferred tax liabilities and assets relate to income taxes levied by the same tax authority on either:

- the same taxable entity; or
- different taxable entities, but these entities intend to settle current tax liabilities and assets on a net basis, or their tax assets and liabilities will be realised simultaneously for each future period in which these differences reverse.

IAS 12.75, 12.B3 The standard further explains that the offset requirements allow an entity to avoid having to schedule the timing of reversal of temporary differences. In our view, this relates only to the presentation of deferred tax liabilities and assets, and not to the underlying recognition criteria (see 3.12.4).

For example, entity P has a deferred tax asset of 100 in respect of a provision for environmental expenditure. For tax purposes the expenditure is deductible as incurred, which is expected to be in two years' time. P also has a deferred tax liability of 300 in respect of property, plant and equipment,

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of which 150 is expected to reverse in two years' time and the remaining 150 in four years' time. Following the recognition criteria (see 3.12.4), P can recognise the deferred tax asset on the basis that the reversing deferred tax liability will generate sufficient taxable profit to enable the deferred tax asset to be utilised. Following the offset criteria, on the face of the balance sheet P will present a net deferred tax liability of 200.

3.12.7 Specific application issues

The commentary that follows considers some specific application issues in accounting for deferred tax that cause difficulties in practice.

Business combinations and consolidation

IAS 12.15, 24

In a business combination differences between the tax bases and the fair values of the assets acquired (and liabilities assumed) are temporary differences for which deferred tax is provided. The only exceptions are:

- goodwill for which amortisation is not tax deductible; and
- negative goodwill that is treated as deferred income in accordance with IFRSs#.

For example, entity R acquires an 80 per cent interest in the shares of entity S. One of S's assets is a building with a carrying amount of 200 and a tax base of 150, giving rise to a taxable temporary difference of 50 for which deferred tax has been recognised. As part of the purchase accounting on consolidation (see 2.6) R increases the value of the building by 50, thereby increasing the taxable temporary difference to 100 (250 - 150). Therefore, R recognises an additional deferred tax liability in respect of the temporary difference as part of the purchase accounting.

The tax rate that applies in recognising the resulting deferred tax is the applicable tax rate in the country where the income will be taxed or deductions given. Generally, this is in the country of the acquiree.

Forthcoming requirements

IAS 12.15

IFRS 3 amended the exemption from the recognition of deferred tax in respect of all temporary differences related to goodwill. The revised standard requires that a deferred tax liability (asset) is recognised unless it arises from *the initial recognition of goodwill*.

We do not consider that the change in wording will have any practical impact on the recognition of deferred tax, reflecting simply that goodwill no longer is amortised under IFRS 3.

IAS 12.58

When deferred tax is recognised as part of the purchase accounting in a business combination, the other side of the entry is to goodwill or negative goodwill (see 3.12.6)#.

Forthcoming requirements

IAS 12.66-68

IFRS 3 amended IAS 12 to introduce a major change to the recognition of the effect of a business combination on deferred tax recognised by the acquirer. For example, an acquirer may consider it probable that it will be able to utilise its previously unrecognised tax losses against the future taxable profit of the acquired entity. In such cases, the amended standard requires the acquirer to recognise the deferred tax asset as a gain in the income statement rather than against goodwill (as previously required).

Goodwill

When goodwill is deductible for tax purposes, the recognition of any deferred tax as part of the purchase accounting will depend on the respective carrying amounts of the goodwill for accounting and tax purposes. Continuing the above example, R recognises goodwill of 400 as part of the purchase accounting, which is deductible for tax purposes; the carrying amount of the goodwill for tax purposes also is 400. In this case no deferred tax is recognised at the date of initial recognition

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because the carrying amount of the goodwill is identical for accounting and tax purposes and therefore no temporary difference exists.

Continuing this example, R will amortise the goodwill over 10 years for accounting purposes#; the amount is tax deductible over 20 years. At the end of year one the carrying amount of the goodwill under IFRSs is 360 (400 - 40) and the carrying amount for tax purposes is 380 (400 - 20). If the tax rate is 25 per cent this should result in the recognition of a deferred tax asset of five ((360 - 380) x 25 per cent).

Forthcoming requirements

IFRS 3 Under IFRS 3, acquired goodwill and indefinite lived intangibles are not amortised.

Negative goodwill

IAS 12.32 (2000) Deferred tax is not recognised in respect of negative goodwill when negative goodwill is recognised as deferred income under IAS 22. However, under IAS 22 negative goodwill is never recognised as deferred income; rather, it is recognised as a negative asset (see 2.6). In our view, this discrepancy is a drafting error and the negative asset created under IAS 22 effectively is deferred income and therefore no deferred tax should be recognised in respect of negative goodwill that is recognised as a negative asset.

Movement in deferred tax subsequent to a business combination

Although the deferred tax relating to a business combination is recognised as part of the purchase accounting at the time of the acquisition, subsequent changes in deferred tax are accounted for in the income statement or directly in equity following the general principles for classification and presentation (see 3.12.6).

For example, entity T acquired all of the shares in entity U. At the date of acquisition T increased the carrying amount of property, plant and equipment and recognised the resulting deferred tax liability as part of the purchase accounting. Further changes in this temporary difference that arise after the acquisition as the assets are depreciated should be recognised in the income statement and goodwill is not adjusted.

When deferred tax assets of the acquiree are realised in excess of the amount recognised at the date of acquisition as part of the purchase accounting, goodwill is adjusted in addition to recognising the additional tax benefit in the income statement.

Intra-group transactions

IAS 12.A A14, B11 Intra-group transactions are required to be eliminated upon consolidated (see 2.5). It may be intuitive to reverse not only the transaction itself, but also the tax effects thereof in order to eliminate the transaction fully in the consolidated financial statements. However, the tax effects are not eliminated unless the transacting entities are subject to the same tax rate. This is because the transaction creates a real asset or liability from the point of view of the group.

For example, entity V sells inventory to fellow subsidiary W for 300, giving rise to a profit of 50 in V's separate financial statements. V pays current tax of 15 on the profit. Upon consolidation the profit of 50 is reversed against the carrying amount of the inventory of 300. Therefore, the carrying amount of the inventory on consolidation is 250. However, the carrying amount of the inventory for tax purposes will depend on the legislation in W's jurisdiction. Assuming that the carrying amount of the inventory for tax purposes is 300, a deductible temporary difference of 50 arises, which should be recognised on consolidation at W's tax rate subject to the general asset recognition requirements (see 3.12.4).

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Investments in subsidiaries, branches, associates and joint ventures

IAS 12.39

Taxable temporary differences in respect of investments in subsidiaries, branches, associates and joint ventures are not recognised if:

- the investor is able to control the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

IAS 12.44

Deductible temporary differences in respect of investments in subsidiaries, branches, associates and joint ventures are recognised only to the extent that it is probable that:

- the temporary difference will reverse in the foreseeable future; and
- taxable profit will be available against which the temporary difference can be utilised.

The timing and nature of reversal

The temporary differences associated with investments in subsidiaries, branches, associates and joint ventures will fluctuate from period to period, for example, due to movements in exchange rates and the profitability of the investee.

IAS 12.39, 44

In our view, the reversal of the temporary difference means its crystallisation rather than its fluctuation. For example, in our view, changes in exchange rates do not cause the reversal of the temporary difference; rather, they change its size. However, the disposal of an investee or the payment of dividends by the investee does reverse the temporary difference, either in full or partially. Sometimes when a taxable temporary difference associated with an investment in a subsidiary, branch, associate or joint venture crystallises, a related tax deduction will be recognised. As an illustration, consider the example of entity X incorporated in the United Kingdom and its foreign subsidiary Y. If Y pays a dividend to X of 100, tax of 30 will be deducted at source in Y's country of incorporation. However, X itself will be allowed a deduction of 10 for the tax incurred. In our view, the tax effect of the temporary difference is 20 (i.e., the net exposure to tax).

The foreseeable future

IAS 12.39, 44

IAS 12 refers to the reversal of the temporary difference in the "foreseeable future", but the term is not defined. In our view, it is necessary to consider in detail a period of 12 months from the balance sheet date, and also to take into account any transactions that are planned for a reasonable period after that date.

In practice the assessment of "foreseeable future" should be made on a case-by-case basis, taking into account the entity's history and the certainty of its plans. Continuing the above example, X plans to draw dividends of euro 200 from Y in 18 months' time; X estimates that euro 150 of that amount will relate to post-acquisition earnings already recognised in the financial statements. In our view, 18 months is within the foreseeable future and the deferred tax related to the planned euro 150 distribution should be recognised. If the facts were different and the dividend was planned to be paid in five years' time, we believe that generally the related deferred tax should not be recognised because five years is a considerable period during which time plans may change.

IAS 21.15

When a loan to an investee is accounted for as an integral part of the investor's investment, in our view it should be assumed that any temporary difference associated with the loan will not reverse in the foreseeable future through repayment. This is because IAS 21 requires that repayment must not be planned nor likely to occur in the "foreseeable future" in order to allow classification as part of the investment (see 2.7).

Investments in subsidiaries or branches

IAS 12.39, 44

Since an entity controls an investment in a subsidiary or branch, generally there is no need to consider whether the entity can control the timing of the reversal of a taxable temporary difference. The key issue is whether the temporary difference will reverse in the foreseeable future, and if so,

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how it will reverse; and in relation to a deductible temporary difference, whether the asset recognition criteria are met.

IAS 12.51 For example, if subsidiary A pays dividends to its parent B, a dividend tax of 10 per cent will be incurred. However, if B disposes of its investment, tax of 30 per cent will be incurred on the reversal of the temporary difference. The measurement of deferred tax should reflect the manner in which the entity expects to recover the carrying amount of the investment. B plans to dispose of its investment in A within the next year and accordingly the deferred tax liability is calculated using a tax rate of 30 per cent.

Investments in associates

IAS 12.42 An investor does not control an associate (see 3.5) and therefore is not in a position to control the associate's dividend policy. Therefore, a deferred tax liability must be recognised unless the associate has agreed that profits will not be distributed in the foreseeable future.

In our view, the decision whether or not to recognise a deferred tax liability, and if so how much, should be analysed as follows:

- If the entity has a plan to dispose of its investment in the associate in the foreseeable future, the deferred tax should be based on the tax consequences of disposal, taking into account any recovery of the carrying amount through dividends until the date of disposal.
- In other cases it should be assumed that the carrying amount of the associate will be recovered through dividends except to the extent that there is an actual agreement regarding the level of dividends that will be paid.

For example, entity C acquired a 25 per cent equity interest in associate D for 1,000. Since acquisition D has followed a dividend policy of distributing a third of its profit for the year, but there is no shareholders' agreement in this respect. At the end of 2004 the carrying amount of D in C's consolidated financial statements is 1,500. For tax purposes the investment has a cost of 1,000. The tax laws under which C operates stipulate that dividends received from associates are tax-exempt. On disposal of the investment, any realised capital gains are subject to tax at a rate of 40 per cent. C has no intention of selling its investment in D. In our view, no deferred tax will be recognised since there is no intention to dispose of the investment in the foreseeable future.

Changing the facts of the above example, dividends received by C attract tax at a rate of 20 per cent. In our view, a taxable temporary difference of 100 (1,500 - 1,000 x 20 per cent) should be recognised.

Investments in joint ventures

Whether or not a joint venturer is in a position to control a joint venture's dividend policy will depend on the terms of the joint venture agreement. In our view, a venturer's ability to veto the payment of dividends is sufficient to demonstrate control for the purpose of recognising deferred tax.

Foreign currencies and hyperinflation

IAS 12.41 Sometimes, temporary differences are created when changes in exchange rates lead to changes in the tax basis rather than the book basis. For example, an entity based in the United Kingdom may have some operations in Germany for which sterling is the functional (measurement) currency (see 2.7). As a result, non-monetary fixed assets in Germany are translated into UK sterling once, using the historical rate at the transaction date.

If the asset is part of a unit paying tax in Germany, the tax basis in euro must be retranslated from euro to sterling at each balance sheet date using a current rate. This translation difference may create temporary differences. A liability is recognised for this temporary difference in accordance with the general principles for recognising income tax assets and liabilities (see 3.12.3 and 3.12.4). The tax effect of the temporary difference is recognised in the income statement.

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IAS 12.41, 12.A A17, B13 This applies even when the non-monetary assets are part of a foreign operation that is integral to the operations of the parent (see 2.7)#. In that case the special recognition criteria regarding subsidiaries, associates and joint ventures do not apply because the non-monetary assets are those of the entity itself – not the overall investment.

IAS 12.A A18 Temporary differences arise when current purchasing power adjustments are made to assets of entities operating in hyperinflationary economies (see 2.4) if the value in the financial statements is increased but the tax base remains stated in the historical measuring unit. Such temporary differences are recognised in full.

Forthcoming requirements

IAS 21 The revised IAS 21 eliminates the previous translation regime for a foreign operation integral to the parent but the same result is achieved if the "branch" has the same functional currency as its parent.

This area of IFRSs may be subject to future developments (see 3.12.9).

Income tax exposures

The term "income tax exposures" generally refers to positions taken by an entity that may be challenged by the tax authorities, and which may result in additional taxes, penalties or interest, or in changes in the tax basis of assets or liabilities, or changes in the amount of available tax loss carry-forwards that would reduce a deferred tax asset or increase a deferred tax liability. Examples of tax exposures include:

- deductions taken on tax returns that may be disallowed by the tax authorities;
- transactions structured to utilise existing tax loss carry-forwards that may otherwise expire unused; and
- transactions that could affect an entity's non-taxable or tax-exempt status.

IAS 12.5 Income tax exposures are not discussed directly in IFRSs. However the following definitions are relevant:

- Current tax is the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for a period.
- Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

IAS 12.88 To the extent that a tax exposure affects the calculation of income tax in respect of the current or prior periods, it falls within the definition of current tax. To the extent that a tax exposure affects the carrying amount of an asset or liability for accounting or tax purposes, it falls within the definition of deferred tax. In our view, interest and penalties arising from tax exposures do not fall within the definition of income taxes, and should be accounted for in accordance with IAS 37 (see 3.11) and presented as other provisions (liabilities).

In our experience entities assess their potential obligations for income tax exposures following the measurement guidance in IAS 37. This is done by analysing potential tax exposures individually and determining a best estimate of the probable amount to be paid in each case. However, in our view, the definition of "probable" used in determining the amount to be provided should be consistent with the approach taken by the entity in the context of IAS 12 (see 3.12.5) since we believe that tax exposures are income taxes within the scope of IAS 12.

Investment tax credits

Definition

There is no formal definition of investment tax credits (ITCs) under IFRSs. In our view, it is necessary to consider the substance of a tax credit to determine if it is more akin to a credit received for investment in a certain area, or simply a reduction in the applicable tax rate. For example, entity E

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receives a tax credit for a period of five years, which does not relate to specific expenditure being made or any spending on a particular asset. However, in order to continue being eligible for the tax credit E must achieve a certain profit and employ a certain number of staff. In our view, this tax incentive is not an ITC in substance because it does not relate to specific expenditure or required spending on a particular asset. In this example, in our view the tax credit is a reduction in the applicable tax rate during the period that it is received.

In another example, entity F acquires a certain machine and thereby qualifies to receive a credit against its tax of 100 per year for the next five years as long as no dividends are declared during that period. In our view, the credit is an ITC.

In a further example, entity G acquires a certain machine and receives a tax deduction equal to 150 per cent of its cost (referred to as "bonus depreciation") as an incentive to invest in that kind of machinery; there are no additional requirements that must be fulfilled. In our view, the additional tax deduction received is an ITC.

Accounting

ITCs are excluded from the scope of both IAS 12 (see 3.12.1) and the standard on government grants IAS 20 (see 4.3). However, in practice entities generally account for ITCs using one of these two standards by analogy; in our view, either approach is acceptable as long as it is applied consistently:

- Following IAS 12 by analogy, ITCs are presented in the income statement as a deduction from a current tax expense to the extent that an entity is entitled to claim the credit in the current reporting period. Any unused tax credit is recognised as a deferred tax asset if it meets the recognition criteria (see 3.12.4).
- Following IAS 20 by analogy, ITCs are recognised as income over the periods necessary to match them with the related costs that they are intended to compensate. In the income statement ITCs are presented either as "other income" or as a deduction from the related expense. Unused ITCs are presented in the balance sheet as deferred income or as a deduction from the carrying amount of the related asset.

3.12.8 Disclosure

IAS 12.79-88

IAS 12 requires extensive disclosures, which are illustrated in KPMG's *Illustrative financial statements* series. This commentary focuses on areas of uncertainty in practice.

IAS 12.81(c), 85

A reconciliation between the applicable statutory tax rate and the entity's effective tax rate (expressed in percentages or in absolute numbers) is required. The applicable tax rate can be determined in one of two ways for a group that operates in multiple tax jurisdictions:

- based on the statutory tax rate applicable to the parent entity: in this case the reconciliation will include a separate line item representing the effect of tax rates in different jurisdictions; or
- using the average statutory tax rate applicable to the group, calculated on a weighted average basis.

IAS 12.81(f), 87, 12.B3

Unrecognised temporary differences in respect of investments in subsidiaries, associates and joint ventures (see 3.12.7) must be disclosed. The disclosure is not of the amount of unrecognised deferred tax; rather, it is the gross temporary difference. For example, P has acquired entity Q and Q has recognised post-acquisition earnings of 500 in its consolidated financial statements. If these earnings were distributed, tax of 50 would be payable by P. P did not recognise this deferred tax since it met the criteria for non-recognition. In the notes to the financial statements of P the temporary difference of 500 should be disclosed. In addition, entities are encouraged to disclose the tax consequences of a distribution – 50 in this example.

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IAS 12.81(g) An entity is required to disclose, in respect of each *type* of temporary difference, the amount of deferred tax assets and liabilities recognised in the balance sheet. In our view, this could be interpreted in one of two ways:

- Disclosure based on balance sheet captions (e.g., disclosure of deferred tax assets and deferred tax liabilities (separately) in respect of property, plant and equipment) – this method of presentation is shown in KPMG's *Illustrative financial statements* series.
- Disclosure based on the reason for the temporary difference (e.g., excess of wear and tear allowances over depreciation and amortisation).

IAS 12.81 In our view, it is not appropriate to disclose gross deductible temporary differences because, under IFRSs, it is *recognised* temporary differences that are required to be disclosed. The following example illustrates the two methods of disclosure:

Deductible temporary differences	*Inappropriate*	*Appropriate*
Property, plant and equipment	1,000	800
Intangible assets	400	300
Valuation allowance	(300)	-
Total deductible temporary differences	1,100	1,100

However, an entity that wishes to disclose information about its unrecognised temporary differences may include additional disclosure.

3.12.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Convergence project

The IASB and the FASB are considering their respective standards on accounting for income taxes as part of their convergence project. Both IAS 12 and the equivalent United States standard SFAS 109 *Accounting for Income Taxes* are based on the balance sheet liability approach when accounting for deferred taxes. However, differences arise because both standards have many exceptions to their basic principle. The objective of this project is not to reconsider the underlying approach, but rather to eliminate exceptions to the basic principle. As part of this project the IASB has *tentatively* decided to eliminate the current exemption from recognition of deferred tax assets and deferred tax liabilities in IAS 12. An exposure draft as a result of this convergence project is expected in the fourth quarter of 2004.

IFRIC

In March 2004, the IFRIC published a draft interpretation D5 *Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the First Time*. This draft interpretation includes guidance on how to adjust opening deferred tax balances when preparing inflation-adjusted financial statements.

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3.13 Contingent assets and liabilities

(IAS 37)

Overview

- **Contingent liabilities are obligations that are not recognised in the balance sheet due to uncertainties about either the probability of outflows of resources or about the amount of the outflows or possible obligations when the existence of an obligation is uncertain.**
- **Instead details of contingent liabilities are disclosed in the notes to the financial statements, unless the probability of an outflow is remote.**
- **Contingent assets are possible assets whose existence is uncertain.**
- **Contingent assets are not recognised in the balance sheet unless their realisation is virtually certain. If their existence is probable, details are disclosed in the notes to the financial statements.**

3.13.1 Definitions

IAS 37.10, 29 A *contingent liability* is a liability of sufficient uncertainty that it does not qualify for recognition as a provision (see 3.11), because:

- It is a *possible* obligation*:* one whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events. For example, when an entity is jointly and severally liable for an obligation, the portion of the obligation that is expected to be met by other parties is an example of a possible obligation.
- It is an obligation, but it is *not more likely than not* that there will be an outflow so that the probability of an outflow is less than 50 per cent. An example is a claim against an entity that, according to legal opinion, the entity is likely to defend successfully.
- It is a liability, but its amount cannot be estimated reliably. This is expected to be extremely rare.

IAS 37.10 A *contingent asset* is an item whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events.

This area of IFRSs may be subject to future developments (see 3.13.4).

3.13.2 Recognition

Contingent liabilities

IAS 37.27 Contingent liabilities are not recognised in the balance sheet.

IAS 37.14 If the possible obligation relates to a past event, the possibility of an outflow is probable (i.e., more likely than not) and a reliable estimate can be made, then the obligation is not a contingent liability but instead is a liability for which a provision is required (see 3.11).

IAS 37.53 The expectation that an expense will be reimbursed – for example, that an environmental obligation will be covered by an insurance policy – does not affect the assessment of the probability of an outflow for the obligation.

IAS 10.14 If events after the balance sheet date confirm the existence of a liability and the liability affects the entity's ability to continue as a going concern, adjustments may be required (see 2.9).

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Contingent assets

IAS 37.31 Contingent assets are not recognised in the balance sheet.

IAS 37.35 When realisation of a contingent asset is virtually certain, it is no longer considered contingent and is recognised. In our view, virtually certain generally should be interpreted as a probability of greater than 90 per cent.

An item previously regarded as a contingent asset may become virtually certain of being realised, and therefore qualify for recognition. For example, L leases a property to B under an operating lease. The contract is non-cancellable for 10 years. On 30 November 2004, before the end of the contract, B withdraws from the contract and is required to pay a cancellation penalty of 450,000. In our view, L should recognise a receivable of 450,000 and corresponding income once B cancels the contract, if it is virtually certain that the cancellation penalty will be received.

However, an asset should not be recognised until the contract is cancelled. For example, if in the above example B had cancelled the contract on 28 February 2005, L would not recognise a receivable for the cancellation penalty on 31 December 2004. The event that gives rise to the asset is the cancellation of the contract. Therefore, if the cancellation happens only after the balance sheet date, an asset is not recognised at the balance sheet date.

3.13.3 Disclosure

Contingent liabilities

IAS 37.86 Contingent liabilities are disclosed unless an outflow is only remotely likely. Disclosure includes the nature of the contingency and, when practicable, the estimated financial effect, an indication of the uncertainties and the possibility of any reimbursement. When disclosure of any of the latter is impractical, that fact must be stated.

The type of information that should be disclosed in respect of a contingent liability related to a legal claim includes:

- an explanation of the claim;
- the fact that no liability has been recognised;
- an explanation of why the entity does not accept liability under the claim;
- information about the amount of the claim or an explanation of why this cannot be estimated reasonably; and
- information about any reimbursements that may be claimed if the defence is not successful, for example, amounts that are reimbursable under an insurance policy.

The type of information that should be disclosed in respect of a financial guarantee includes:

- the existence of the guarantee;
- the terms of the guarantee;
- the maximum amount payable under the guarantee;
- the fact that a provision has not been recognised and the reasons; and
- details of any security held in respect of the guarantee.

IAS 37.92 In the extremely rare case when the disclosure could seriously prejudice the entity's position in a dispute with another party, the entity need only disclose the general nature of the dispute and the reasons for not disclosing the information (see 3.11).

IAS 1.23 If crystallisation of a contingent liability would affect an entity's ability to continue as a going concern, additional disclosures are required.

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Contingent assets

IAS 37.89 Contingent assets are disclosed when an inflow of economic benefits is considered more likely than not to occur. The disclosure includes the nature and, when practicable, the estimated financial effects of the contingent asset.

3.13.4 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Changes to the definitions of contingent assets and contingent liabilities are likely as part of phase II of the IASB's project on business combinations (see 2.6). In its October 2003 meeting, the IASB tentatively agreed to change the definitions of contingent assets and contingent liabilities as follows:

- A *contingent asset* is a conditional right that arises from past events from which future economic benefits may flow based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
- A *contingent liability* is a conditional obligation that arises from past events that may require an outflow of resources embodying economic benefits based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

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4. Specific income statement items

4.1 General

(IAS 1, IAS 8)

Overview

- **An analysis of expenses is required, either by their nature or by function, on the face of the income statement or in the notes.**
- **When expenses are classified by function, depreciation, amortisation and restructuring costs should, in most cases, be allocated to the appropriate functions and not shown separately.**
- **The results of operating activities are presented as a separate line item on the face of the income statement#. "Results of operating activities" is not a defined item.**
- **Items of income and expense are not offset unless required or permitted by another IFRS or when the amounts relate to similar transactions or events that are not material.**

Forthcoming requirements

In December 2003, the IASB issued revised versions of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The revised standards are effective for accounting periods beginning on or after 1 January 2005. Early adoption is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standard:

- does not require presentation of the results of operating activities (operating results); and
- prohibits the presentation or disclosure of items as 'extraordinary' (see 4.8).

4.1.1 Format of the income statement

IAS 1.81, 82 While the format of the income statement is not prescribed, certain items are required to be presented on the face of the income statement. In practice there is limited flexibility as to the order of these items. The chosen format should be applied consistently.

IAS 1.83 Additional line items, headings and sub-totals also are given when this is necessary to achieve fair presentation (see 4.1.4).

This area of IFRSs may be subject to future developments (see 4.1.13).

4.1.2 Classification of expenses

IAS 1.88, 89 Expenses are classified according to their nature (e.g., staff costs, depreciation and amortisation) or function (e.g., cost of sales, distribution or administration). This analysis may be given on the face of the income statement or in the notes. In our view, it is preferable for the analysis to be presented on the face of the income statement, and this is the approach followed in practice for most financial statements presented under IFRSs.

IAS 1.88 An entity must elect either classification by nature or by function. The choice often depends on the nature of the entity and the industry in which it operates. For example, an entity that sells goods normally would classify expenses by function.

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IAS 1.27 The chosen classification must be applied consistently. A change of classification can be made only if there is a significant change in the nature of the operations or if the change will result in more appropriate presentation.

Classification by function

IAS 1.92 When expenses are classified according to function, expenses are allocated to cost of sales, distribution or administrative activities. Only expenses that cannot be allocated to a specific function are classified as "other operating expenses".

There is no guidance in IFRSs on how specific expenses should be allocated to the functions. An entity should establish its own definitions of functions such as cost of sales, distribution and administrative activities and apply these definitions consistently. It may be appropriate to disclose the definitions used.

IAS 1.93 All costs, including staff costs, depreciation and amortisation, should be allocated to the appropriate functions. In our view, depreciation and amortisation can be allocated to specific functions in almost every case. The only exception is goodwill amortisation, which sometimes cannot be allocated and therefore sometimes is included in other operating expenses (see 4.1.5).

IAS 1.93 Additional information based on the nature of expenses (e.g., depreciation, amortisation and staff costs) is disclosed in the notes to the financial statements.

Cost of sales

In our view, cost of sales should include only costs directly attributable to the production process. For example, depreciation of assets used in manufacturing and repair and maintenance costs related to production should be allocated to cost of sales. Indirect costs such as marketing and advertising costs should be classified as selling and distribution costs.

Classification by nature

IAS 1.91 When a classification by nature is used, expenses are aggregated according to their nature (e.g., purchases of materials, transport costs, depreciation and amortisation, staff costs and advertising costs).

4.1.3 Employee benefits, amortisation and restructuring expenses

Employee benefits (staff costs)

IAS 1.91, 93 Staff costs are presented separately if expenses are classified by nature. In addition, staff costs are required to be disclosed in the notes if expenses are classified by function.

There is no specific guidance on what to include in staff costs. In our view, all costs directly attributable to personnel should be included (e.g., salaries, social security expenses, pension costs and health benefits).

In some countries housing and other infrastructure assets (e.g., schools) are provided to staff and their families. When this is the case, in our view any rent paid should be included in staff costs. If the property is owned by the employer, in our view, depreciation and maintenance of the property should be included in staff costs.

Amortisation of goodwill#

In our view, goodwill amortisation is an operating expense and should be included in the determination of operating income. However, goodwill amortisation could be disclosed as a separate component of operating income, if it cannot be allocated to functions or if expenses are classified based on their nature.

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Forthcoming requirements
In March 2003, the IASB issued IFRS 3 and amendments to IAS 38. Upon adoption of these new requirements goodwill will no longer be amortised, but instead it is subject to impairment testing at least annually (see 3.3).

Restructuring expenses

In our view, restructuring costs normally should be presented as part of operating income as they represent costs of restructuring ongoing operations. If the restructuring charge is large, it may be appropriate to present it as a separate item on the face of the income statement within profit or loss from operating activities (see 4.8).

IAS 37.84 (a), (b)

When expenses are classified by function, in our view restructuring costs should be allocated to the functions. Separate presentation on the face of the income statement is acceptable only if the restructuring costs cannot be allocated to a specific function (e.g., if the restructuring relates to a newly acquired company). The total cost recognised in respect of restructurings must be disclosed in the notes to the financial statements.

See 4.8 for additional guidance on income statement presentation of restructuring activities.

4.1.4 Additional items

IAS 1.83

An entity presents additional items of income or expense, headings or sub-totals when relevant to an understanding of the entity's financial performance. Factors to consider when determining whether to present additional items include materiality and the nature and the function of the components of income and expenses.

IAS 1.29-31, 84

Materiality is a factor when making judgements about disclosure, for example, when items may be aggregated, the use of additional line items, headings and sub-totals. It also is relevant to the positioning of these disclosures – an item may be sufficiently material to warrant disclosure on the face of the income statement or to require disclosure only in the notes to the financial statements. It even may mean that a specific disclosure requirement in a standard or an interpretation need not be satisfied if the information is not material#.

Forthcoming requirements
The revised standards amplify the use of materiality as a factor in considering the presentation or disclosure of additional items (see 1.2).

IAS 1.11, 8.5

Materiality is defined by illustration. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

4.1.5 Operating result

IAS 1.75 (1997)

The results of operating activities (i.e., operating result) are required to be presented as a separate line item on the face of the income statement#.

Forthcoming requirements

IAS 1.81

The disclosure of results of *operating* activities no longer is required as a separate line item on the face of the income statement. Further, no items of income and expense may be presented as arising from outside an entity's *ordinary* activities (see 4.8).

Entities may continue to provide a sub-total before profit or loss for the year. In our view, results from operating activities may be an appropriate sub-total.

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IAS 7.6

The terms "operating" and "non-operating" are not defined in the context of the income statement. However, the standard on statements of cash flows defines "operating activities" as "the principal revenue-producing activities of an entity...". Most entities also use this definition as a starting point in determining the components of operating income.

In our view, only items that clearly are not related to the ongoing activities (e.g., profit on the sale of a business or financing activities) should be presented outside of operating result.

In our view, gains and losses on disposal of property, plant and equipment generally are part of the operating activities of an entity and should be shown below gross profit but within operating results, perhaps as part of other operating income or expense. The gain or loss on disposal often is viewed as an adjustment to depreciation previously charged (see 3.2). This is an example of when the cash flow and income statement effect of a single transaction is classified differently in each of the two statements as the cash proceeds of sale would be presented within investing activities in the cash flow statement and not as operating cash flow (see 2.3).

4.1.6 Sales of financial investments

Profits or losses on the disposal of financial investments generally should be included in financial income or expense.

In our view, entities that trade routinely in financial instruments, or for which investing activities are part of the ordinary operations, should present the net results of these activities within operating result. The gross proceeds on disposal of investments generally are not presented as revenue in the income statement.

4.1.7 Share of profit of associates

IAS 1.81, 28.38

Share of profit of associates should be presented as a separate line item. There is no specific guidance on where in the income statement the line item should be presented. In our view, it should be presented as part of profit or loss from ordinary activities before tax; and may be shown either as part of operating result or financial income.

For further guidance see 3.5.

4.1.8 Alternative earnings measures

An entity may wish to present alternative earnings measures such as EBITDA (earnings before interest, tax, depreciation and amortisation), EBIT (earnings before interest and tax) or headline earnings in the income statement. IFRSs do not prohibit alternative earnings measures being presented, but the requirement to classify expenses by nature or function sometimes precludes presentation of alternative earnings measures.

Various options based on the income statement presentation requirements in IFRSs are discussed below. Regulations may prohibit various presentation formats, and therefore these also should be considered. For example, according to the United States Securities and Exchange Commission, non-GAAP measures (e.g., EBITDA, "special" earnings per share) should be shown outside the financial statements.

In our view, if a measure of performance such as EBITDA or EBIT is presented in the financial statements, a definition, and possibly a reconciliation, of the earnings measure to sub-totals in the income statement should be given so that users are clear regarding the elements of revenue and expense that are included and excluded from the measure.

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EBITDA

The presentation of EBITDA on the face of the income statement depends on the classification of expenses adopted, and whether the classification is given on the face of the income statement or in the notes.

In our view, presentation of EBITDA usually is possible by presenting a sub-analysis of earnings while classifying items of income and expenditure to the appropriate line item.

For example, the income statement could be presented as follows:

Extract from income statement		
Revenue		500
Expenses (classified by nature or function either on the face of the income statement or in the notes to the financial statements)		(400)
Analysis of profit from operations:		
Profit before interest, taxes, depreciation and amortisation (EBITDA)	120	
Depreciation and amortisation	(20)	
Profit from operations		**100**

As an alternative, an entity could disclose EBITDA as a footnote to the income statement beneath earnings per share, in a note to the financial statements, or as supplemental information.

If an entity elects to classify its expenses by nature, it also is possible to present EBITDA as a sub-total on the face of the income statement. For example:

Extract from income statement	
Revenue	500
Other operating income	10
Changes in inventories of finished goods and work-in-progress	(20)
Work performed by the entity and capitalised	10
Raw material and consumables used	(200)
Staff costs	(100)
Other operating expenses, other than depreciation and amortisation	(80)
Profit before interest, taxes, depreciation and amortisation (EBITDA)	**120**
Depreciation and amortisation	(20)
Profit from operations	**100**

EBIT

It is possible to show EBIT on the face of the income statement, regardless of the classification of expenses or the entity's definition of interest for the purposes of EBIT. For example, an entity that excludes foreign exchange gains and losses from its definition of interest but includes these gains and losses in financing result might present EBIT as follows:

Extract from income statement			
Profit from operations			100
Net foreign exchange losses		(30)	
Profit before interest and taxes (EBIT)	**70**		
Interest income		20	
Interest expense		(30)	
Net financing results			(40)
Profit before tax			**60**

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IAS 1.81 Although finance costs should be presented separately on the face of the income statement, in our view, the above split between interest and other finance costs is acceptable. Some entities that present EBIT include all finance costs in the interest line. In our view, this also is acceptable, as long as the definition of EBIT is clear.

4.1.9 Changes in estimates

IAS 8.28 (1993) Changes in estimates, for example, reversals of provisions or impairment losses, should be presented in the same income statement line item (classification) as the original estimate.

Therefore, in our view, if the original estimate was classified as "other operating expenses", changes in the estimate, whether they are additional charges (debits) or reductions in amounts previously charged (credits) also should be presented in "other operating expenses". When appropriate, additional disclosure should be provided in the notes (or on the face of the income statement, see 4.8) of the nature and amounts of the original and revised estimates.

Sometimes it may be acceptable to present the effect of a reduction in an estimate of an expense within other operating income even if the original estimate was classified as other operating expenses. This might be appropriate when, for example, the reversal is very significant and otherwise would result in the line item "other operating expenses" being a net credit. In this situation it is our preference for "other operating income" and "other operating expenses" to be presented in consecutive line items.

4.1.10 Income tax

IAS 12.77 In our view, all items of ordinary income and expense are required to be presented in the income statement before the effect of income tax (i.e., gross). This is because IFRSs require all income tax to be presented in the tax expense, except for amounts presented directly in equity.

4.1.11 Offsetting

IAS 1.30, 32 Items of income and expense are offset when required or permitted by an IFRS; or when gains, losses and related expenses arise from the same transaction or event or from similar individually immaterial transactions and events. For example, in our view, if an entity buys, and then within a short time sells, foreign currency, the transactions should be presented on a net basis in the income statement.

In our view, when a financial asset and financial liability qualify for offset (see 5.6), the related income and expense items also should be offset.

4.1.12 *Pro forma* income statement

When there have been significant changes in the structure of an entity (e.g., following a major business combination) the entity may wish to present a *pro forma* income statement. IFRSs do not prohibit such presentation, but in our view, any *pro forma* information should be identified clearly as such and presented in a manner that is not misleading (see 5.8). Also, the basis of preparation of the *pro forma* information should be explained clearly.

Although a *pro forma* income statement may be appropriate as supplemental information it is not a substitute for an income statement that complies with IFRSs.

4.1.13 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The Board's project on performance reporting is expected to affect significantly the presentation of items in the income statement. At this stage both the timing of the project and the nature of the changes are uncertain.

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4.2 Revenue

(Framework, IAS 1, IAS 11, IAS 17, IAS 18, SIC–27, SIC–31)

Overview

- **Revenue is recognised only if it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably.**
- **Revenue includes the gross inflows of economic benefits received by an entity on its own account. In an agency relationship, amounts collected on behalf of the principal are not recognised as revenue by the agent.**
- **Revenue from the sale of goods is recognised when the entity has transferred the significant risks and rewards of ownership to the buyer and it no longer retains control or managerial involvement in the goods.**
- **Revenue from rendering of services and construction contracts is recognised in the period that the service is rendered.**
- **Royalties are recognised on an accrual basis, generally on a straight-line basis over the period of the agreement.**
- **Revenue recognition does not require cash consideration. However, when goods or services exchanged are similar in nature and value, the transaction does not generate revenue.**

IAS 18 contains general principles for revenue recognition that apply to all entities. There is limited supplemental industry-specific guidance in IFRSs on revenue recognition. For example, there is no specific guidance for the recognition of revenue and costs by entities in the software industry. The guidance in IAS 11 relates to construction contracts (see 4.2.8). IAS 11 also generally is applied to non-construction contract service revenue.

The appendix to IAS 18 contains examples illustrating how to apply the general guidance in the standard to specific types of transactions.

4.2.1 Definition

IAS 1.34, 18.7

The definition of revenue is similar to the Framework definition of income (see 1.2). Revenue is income that arises in the course of the ordinary activities of the entity (e.g., the sale of inventory). Other income (i.e., income that arises not in the course of the ordinary activities of the entity), such as sale of an entity's property, plant and equipment, is not revenue but is a gain (or loss), and falls outside the scope of IAS 18. However, in our view, the requirements of IAS 18 (e.g., evaluating the extent to which risks and rewards are transferred) are considered to determine the timing of recognition of any gain or loss.

Contributions by shareholders in their capacity as shareholders do not generate revenue or income. For example, in our view the forgiveness of a loan granted by a shareholder generally should not be treated as income, but rather as a capital contribution, unless the shareholder was not acting in the capacity of a shareholder (see 3.10).

IAS 18.14, 20

In order to recognise revenue, the seller should have supplied the goods, or performed the services, as agreed. The required actions may be specified in a formal contract such as a purchase order or service agreement. However, revenue recognition does not require written or formal evidence of an arrangement; for example, revenue may be recognised even if a formal purchase order is not prepared. Furthermore, the form and contents of the contract may not correspond with performance and revenue recognition.

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4.2.2 Gross or net presentation

IAS 18.7, 8 Revenue represents the amounts receivable by the entity for its own account. Therefore, revenue is stated at its *gross* amount and is measured before deducting related costs such as costs for materials and salaries.

Agency relationships

IAS 18.8 In an agency relationship, amounts collected on behalf of and passed on to the principal are not revenue of the agent. The revenue of the agent is the amount of commission, plus any other amounts charged by the agent to the principal or other parties.

The principal in an agency relationship recognises the gross amount charged to the ultimate customer as revenue. Commission paid to the agent is accounted for as an expense by the principal.

In our view, determining whether an entity is acting as an agent or principal is based on an evaluation of the risks and responsibilities taken by the entity including inventory risk and responsibility for delivery of goods or services.

A common example of an agency relationship is a travel agent. Travel agents sell airline tickets to the public generally at a price determined by reference to the market rate, but often pay the airline a discounted amount. The travel agent does not bear any general inventory risk because it does not carry tickets in inventory and only purchases tickets when it receives orders or bookings from customers.

In this case, the travel agent does not bear any inventory risk nor is it responsible for carrying out the services related to the ticket itself, as this is the responsibility of the airlines. In our view, the travel agent provides a service on behalf of various airlines and other suppliers and earns a fee. The travel agent's revenue should reflect only the fee and not the gross amount billed to the customer. In some cases, travel agents may bear some credit risk, for example, when corporate customers have an account with the travel agent and settle the account only after the travel agent has paid the airline for the ticket. In our view, the fact that the agency sometimes bears credit risk is not a determinative factor and does not compel the agency to reflect the gross billing as revenue.

Usually an entity working as an agent or broker does not assume the risks and rewards of ownership of goods. In our view, the following guidance which reflects indicators identified under national GAAPs including US GAAP (EITF 99-19) and UK GAAP (FRS 5 Application note G) should be considered to determine if an entity is acting as a principal or an agent (none of the indicators noted below should be considered presumptive or determinative).

- Indicators that an entity is acting as a *principal* include that it:
  - is responsible for providing the goods and services desired by the ultimate customer, and takes responsibility for fulfilment of an order
  - takes title to the goods
  - has risks and rewards of ownership, such as the risk of loss for collection (credit risk other than for the commission or fee), general inventory risk before delivery or after returns, or inventory risks during shipping
  - has discretion in establishing prices
  - modifies the product or performs part of the services
  - has discretion in selecting the supplier used to fulfil an order
  - is involved in the determination of product or service specifications
- An indicator that an entity is acting as an *agent* is that it performs services for compensation on a commission or fee basis.

As an example, A operates an Internet site from which it will sell T's products. Customers place orders directly on the Internet site and provide credit card details for payment. A receives the order

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and authorisation from the credit card company, and passes the order on to T, who ships the product directly to the customer. A does not take title to the product and has no risk of loss or other responsibility for the function or delivery of the product. T is responsible for all product returns, defects, and disputed credit card charges. The product typically is sold for 175 from which A receives a commission of 25. In the event a credit card transaction is rejected, A loses its margin on the sale (i.e., the 25).

In our view, A should recognise its fee of 25 as revenue, as it does not take title to the product or take on any of the risks and rewards of ownership of the product. In addition, its credit risk is limited to its fee of 25.

In some cases, an agent may be exposed to some risk, for example, credit risk on the entire amount; but in these cases, it is likely that the commission earned by the agent includes a premium for taking on the risk.

For example, a mobile phone company (M) gives its customers the opportunity to purchase certain goods via their mobile phone. The customers dial a third party supplier and purchase the goods they want, which are provided by the supplier. M invoices the customers for the retail price of the goods. The supplier invoices M for the retail price of the goods less a fee. If the customer fails to pay the invoice, in some cases M bears the credit risk and in other cases it is borne by the supplier. M does not assume any ownership risk with respect to the goods. When M does take credit risk, the commission M earns includes a premium for taking the credit risk.

M acts as an agent by providing a link between the customer and the supplier. Although the customer pays M and not the supplier directly, this is similar to a travel agent (as above) who receives full payment from the customer. In our view, revenue should be recognised by M as follows:

- revenue should be reported on a net basis in the cases where M does not take the credit risk.
- when M takes the credit risk, M is acting in two capacities:
  - as an agent to link the customer and supplier; and
  - as a collection agent.

We believe that the services performed by M should be split into two components. Revenue will be recognised on a net basis but the collection agent component of the fee should be recognised over the period that those services are performed.

When M does take credit risk, but the gross receivable is not recognised on the balance sheet, disclosures are required by IAS 32 (see 5.6).

The risks borne by the agent may not be limited to credit risk and should be considered to determine whether they are significant and result in that entity acting as a principal.

For example, a film distributor agrees to distribute films on behalf of a producer and the only risk borne by the distributor is the responsibility for replacing the film if it is lost in transit. In our view, when the cost of a replacement copy is small, this risk is not material. In this case, the distributor does not take ownership of the films, is not at risk if the films are faulty, does not determine prices and does not take any credit risk, other than in relation to its commission. Therefore, we believe that the distributor should report, as revenue, only its distribution fee and should not include amounts collected from theatres on behalf of the producer as revenue.

Costs incurred on behalf of customers

It is necessary to distinguish between any amounts received from customers in exchange for goods or services provided to them, and amounts *paid on behalf* of customers, which will be reimbursed.

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Amounts paid on behalf of customers should be accounted for as a receivable in the balance sheet until settled and should not gross up revenue and expenses (e.g., sales taxes).

Conversely, amounts received from customers in exchange for services rendered should be recognised as revenue. For example, the principal activity of S is structuring finance transactions, for which it earns a fee. When developing and executing the transactions, S hires tax lawyers to advise on the transactions and to draft documentation.

In our view, S should report revenue gross (i.e., not deducting legal fees). The legal fees are S's operating costs that are incurred to generate fee revenue, regardless of whether transactions are successful or not. S does not incur the legal fees on behalf of its clients nor is it collecting fees on behalf of the lawyer.

To determine whether revenue should be presented gross or net of costs incurred, the entity considers whether it is acting in the capacity of an agent or a principal. In our view, in these cases, the entity should consider:

- when the seller has the freedom to determine the amount to charge to the customer, this indicates that the seller acts as the principal, while a requirement to pass on the actual costs incurred indicates that the seller acts as an agent; and
- when the seller is exposed to changes to the actual costs and cannot pass on price changes to the customer, this indicates that the seller is acting as a principal.

Transport costs

Sellers often incur transport costs on the delivery of goods sold to customers. For example, E sells steel (both domestically and to foreign markets) and arranges the transport of that steel to its customers. E enters into contracts for the transport directly with the transporter. For domestic sales, *customers* of E can choose to arrange for their own transportation or it can arrange transportation through E; E recharges its customer the actual cost plus a fee. With respect to export sales, transportation services are included in the cost in the sales contract. E does not charge the export customer separately for delivery expenses, but merely includes an export charge to the customer, which is calculated by E to include recovery of the *expected* transport charges.

Agent sales

In our view, E acts as an agent with respect to the transport costs for its domestic customers, as the customer bears the risk for any changing transport prices and E may not adjust transport prices. In our view, while E bears the credit risk of the customers, it is not a significant risk in this case. Therefore, we believe that E should report revenue from domestic sales (including the commission charged for transport costs) net of transport costs incurred.

Principal sales

The selling price of the goods is set to recover the expected transport costs. E bears the price risks relating to the transport, as it will not pass any unexpected transport price fluctuations onto the customer when billing for the transaction. Further, E has the freedom to set and change the prices it charges to the customer in respect of the transport costs (as these are costs that are included in the determination of the overall selling price). In our view, E is acting as the principal in respect of the transport and therefore revenue is presented on a gross basis. The transport costs are presented as part of cost of sales.

Lease arrangements

In another common example, an entity leases out property and the fixed monthly rent payment includes both the right to use the premises and the water and electricity usage. In our view, it would not be appropriate to net the utility costs against revenue or otherwise allocate a portion of revenue as reimbursement of the utility costs. This is because, in this case, the landlord bears the

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risks of price and volume fluctuation associated with the actual consumption of water and electricity by the tenant.

If, however, the rent includes only the right to use the premises and the tenant also agrees to refund the landlord for all electricity and water costs, revenue would include only the fixed rental charged. In this case, the property owner has no risks beyond credit risk relating to the actual consumption of water and electricity and the related costs; and, in our view, is acting as an agent on behalf of the utility companies.

Sales taxes

IAS 18.8 Revenue does not include sales taxes, value added taxes (VAT) or goods and service taxes when the entity is acting as a collection agent on behalf of the tax authorities.

In some jurisdictions, excise duties or taxes are levied on particular goods and services, for example, oil and gas products, tobacco products or alcoholic drinks. Excise duties may be computed as a percentage of either the selling price or the production cost.

IFRSs do not specifically address accounting for excise duties. In our view, an analogy with sales tax often is relevant, but the appropriate accounting treatment will depend on the local regulatory requirements. An entity should consider whether it is acting in a manner similar to that of an agent or a principal.

For example, excise duties may be determined based on production levels and are payable to the authorities regardless of whether goods are sold (i.e., the tax payments are not refunded by the authorities if the goods are not sold). In our view, in these cases the tax is another production cost to be recovered in the pricing of the goods. Accordingly, the sales price effectively would be gross of the excise duties recouped from customers.

In another example, duties calculated as a percentage of the selling price may be recouped from the authorities if the buyer defaults. In our view, the seller is likely to be acting as an agent because it does not bear any risk, including credit risk. Under this approach, the amount of excise tax is excluded from revenue and amounts collected are reported as a liability.

In practice, this might lead to different accounting by entities within a multinational group as the approach taken should vary depending on the different tax regimes in various jurisdictions. In our view, if excise taxes are significant, the entity should disclose the line item(s) in which they are included.

For a discussion of accounting for income taxes see 3.12 and 4.7.

Allowances received from suppliers

IAS 1.34 Some transactions do not generate revenue, but are incidental to the main revenue-generating activities of an entity. The results of these transactions are presented by netting any income with related expenses arising from the same transaction when this reflects the substance of the transaction or event.

As an example, retailers may receive consideration from suppliers as a reimbursement of costs incurred. This consideration may be in the form of cash payments or rebates. Guidance consistent with IFRSs may be drawn from US GAAP (EITF 02-16) and, in our view should be treated as follows:

- Consideration received for assets or services delivered to the supplier by the retailer should be recognised in the income statement. It may be presented as revenue by the retailer, if it relates to goods or services sold or delivered in the course of the ordinary activities of the entity, or presented as other income if the activities are incidental to the retailer's main operations.

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For example, a retailer, A, receives a payment from a supplier in respect of the rental of space in its store, including freezer space and prime aisle space. The inventory located in these areas is owned by A. In our view, A is rendering services (the provision of space) to the supplier and the rental income should be presented either as revenue (if the activity is not incidental in nature) or otherwise as other income.

- Consideration that is a reimbursement of costs incurred by an entity to sell the manufacturer's products should be presented as a reduction of that cost incurred by the entity.

  As an example, a retailer, C, distributes a product, X. The supplier of product X agrees to reimburse C for certain marketing costs incurred by C, with payment made on a quarterly basis. In our view, the reimbursement of any costs by the supplier would not qualify as revenue of C and should be offset against the marketing costs that have been incurred by C.

  In our view, when the consideration received exceeds the expense incurred by the entity, this excess amount should be recognised as a reduction of the retailer's cost of sales.

- Consideration that represents a reduction of the prices of the manufacturer's products or services, for example, trade discounts, rebates and other similar items, should be presented as a reduction of the entity's inventory and therefore cost of sales (see 3.7).

4.2.3 Identification of transactions

Revenue may be generated by:

- sales of goods, including goods produced or purchased by the entity for resale (see 4.2.7);
- construction contracts – construction contracts are specifically negotiated contracts for the construction of an asset or a combination of assets if those assets are closely interrelated or interdependent in terms of their design, technology and function or ultimate purpose or use (see 4.2.8);
- rendering of services, typically involving the performance of a contractually agreed task (see 4.2.9); and
- fees such as royalties, dividends and interest received for use of an entity's assets (see 4.6 for guidance on dividends and interest).

IAS 18.13, 18.A11

A contract may include multiple elements, for example, when goods are sold with subsequent support or maintenance services for no additional charge. In these cases it may be necessary to segment the single contract into its components, with different revenue allocations for each component. The amount of revenue allocated to each component should be based on the expected costs to be incurred, together with a reasonable profit for each component.

In other cases, two or more transactions may be linked so that the individual transactions have no commercial effect on their own. In these cases, it is the combined effect of the two transactions together that is accounted for.

In our view, to determine whether a group of transactions should be treated as a single contract or one transaction should be treated as a group of transactions, the guidance for combining and segmenting construction contracts (see below) also should be considered.

It may not be appropriate to link two transactions simply because they are entered into with the same counterparty. For example, F enters into an agreement to provide a telecommunication platform to A from June 2004, for which F will be paid 1,000,000 per month for 24 months. F also enters into an agreement to provide telemarketing services from June 2004, in order to develop A's business and find end users for the future telecom platform. F receives 50,000 per month for

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telemarketing. The costs to provide the telemarketing services exceed 50,000 per month, while the agreement to provide the platform is profitable.

The services specified in the two contracts are provided independently of one another. It also is common industry practice to offer telemarketing services at a discount during the initial term in hopes of securing a long-term customer relationship. In our view, the two contracts may be separate service agreements. If this were the case the combined revenue would not be recognised over the combined period. The entity would recognise a loss on the telemarketing contract and the revenue from the telecom contract would be recognised over the period of that agreement. Further, revenue from providing services may be recognised only when the stage of completion of the transaction at the balance sheet date can be measured reliably. The entity also should consider whether the telemarketing contract is onerous (see 3.11).

Combining and segmenting construction contracts

IAS 11.7, 8

Usually construction contract accounting is applied separately to each construction contract. The components of a contract are accounted for as separate contracts when each segment functions on a stand-alone basis, and the following criteria are met:

- separate proposals were submitted for each component;
- each component was subject to separate negotiation and could have been accepted or rejected; and
- the costs and revenue for each component can be identified.

This area of IFRSs may be subject to future developments (see 4.2.13).

IAS 11.9

A group of contracts (whether with a single customer or not) is treated as a single construction contract when they do not function on a stand-alone basis and:

- they were negotiated as part of a single package;
- the contracts effectively are part of a single project with an overall profit margin; and
- the contracts are performed concurrently or in continuous sequence.

This area of IFRSs may be subject to future developments (see 4.2.13).

Sometimes a contract for a single complex custom-designed item may specify certain milestones (e.g., a development and a production phase). Generally, the contract price is negotiated for the whole contract and customers are not able to reject the development phase and accept the production phase (or *vice versa*). In our view, because separate negotiations are not conducted in respect of the various phases and separate proposals are not submitted for the development and production phases, the contract in this case is not split into the development and the production phase.

Loyalty programmes

Loyalty points and awards often are offered in connection with the sale of goods or services. Such sales may be regarded as having two separate components:

- the goods delivered or the services rendered at the time of purchase; and
- the points awarded.

In some cases, the costs of providing future additional services under the loyalty programme are incidental to the activities of the entity. For example, for the airline industry, the cost is likely to be incidental as long as reward seats are limited so that fare-paying customers are not turned away.

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In our view, if the loyalty programme is incidental to the activities of the entity, then either of the following methods may be applied to recognise revenue from the sale of the goods or services that earns the loyalty points:

- deferral method – a portion of the revenue is deferred because some of the service is still to be provided. The amount deferred is recognised in revenue only when the points are redeemed; or
- incremental method – revenue is recognised based on the stated price of the goods sold or services provided and a provision is recognised for the incremental cost of fulfilling the loyalty award.

Our preference is to apply the deferral method. When the loyalty programme is a significant part of the entity's operations, in our view the deferral method *must* be applied.

When the award or benefit has a cash value, in our view the loyalty programme should not be considered to be incidental. We believe that in these cases the award or benefit is similar to a discount and should be deducted from revenue (see 4.2.5).

Where the deferral method is applied, the amount of revenue deferred is measured based on the fair value of the points awarded. The redemption rate, timing of redemption and any restrictions on the type of award should be taken into account to measure the fair value of the revenue to be deferred.

In our view, the above guidance also is applicable when points or awards are sold to third parties.

Furthermore, in our view, when points are sold to third parties, revenue is earned when the points are used (the services or goods are claimed); revenue is not earned on the sale of the points. Therefore, the amount deferred initially is the compensation received.

4.2.4 Recognition

IAS 18.14, 20, 11.22

Apart from the recognition of interest and dividends (see 4.6), revenue recognition can be categorised under three headings: sale of goods, construction contracts and provision of services, although the approach for the last two is very similar. In all cases there are three common recognition requirements:

- it is probable that the economic benefits of the transaction will flow to the entity;
- the revenue can be measured reliably; and
- the costs (both incurred to date and expected future costs) are identified and can be measured reliably.

Probability of future economic benefits

IAS 18.18

The probability of future economic benefits relates to the collectibility of the revenue. In some cases revenue recognition may not be appropriate until the consideration is received or the cause of uncertainty is removed.

IAS 18.18, 39.58-70

When recoverability of an amount included in revenue in a prior reporting period becomes uncertain, the uncollectable amount is recognised separately as an expense (impairment of the receivable – see 3.6), rather than as a reduction of revenue.

Timing of revenue recognition

The timing of receipt of payment or the pattern of costs incurred by the seller often are not the determining factors when considering the timing of revenue recognition, although they may affect the measurement of the revenue. For example, a customer purchases a particular item from a retailer, which is not in stock, and pays in advance. The retailer agrees to order the item. In this case, no revenue should be recognised by the retailer until the item has been received and shipped or delivered to the customer.

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IAS 18.14, 20 Revenue is recognised only once the risks and rewards of ownership have been transferred, or for sales of services, revenue is recognised by reference to the stage of completion of the transaction (see 4.2.9), if all the other conditions for revenue recognition have been met. For example, W sells prepaid phone cards that are used on the landlines provided by a telecommunications entity (P). W owes payments to P based on the actual time that W's customers use P's network. In our view, revenue from the sale of the cards should be recognised by W over the period that the cards are used (based on the costs incurred by W) and not on receipt of the proceeds of the sale of the cards.

IAS 18.19 The costs related to completing performance should be reliably measurable prior to recognising revenue, and if they are not, revenue recognition is deferred, not only for the portion of the sale to be completed, but also for the goods or services that already have been delivered. In very limited circumstances it may be appropriate to recognise all the revenue while accruing costs related to fulfilling the agreement. In our view, this would be appropriate only when costs to complete, as well as the significance of the remaining component to the product or service, are insignificant. For example, this approach may be appropriate for the costs of fulfilling incidental loyalty programmes (see 4.2.3) or for product warranties (see 4.2.7).

IAS 18.A2 Sometimes, the remaining activity to be performed or product to be delivered is significant (e.g., installation and testing of customised hardware and software) or the sale is subject to customer acceptance (see 4.2.7). In these cases, it may be appropriate to segment the contract into multiple deliverables with separate allocations of revenue. Alternatively, if segmentation is not appropriate or possible (see 4.2.3 and 4.2.8) then it may not be appropriate to recognise any revenue until completion (or acceptance) if the transaction is accounted for under IAS 18.

4.2.5 Measurement

IAS 18.9-11 Revenue is measured at the fair value of the consideration received, taking into account any trade discounts and volume rebates. The amount of revenue recognised is discounted to the present value of consideration due if payment extends beyond normal credit terms.

Discounts and rebates on sales

IAS 18.10 Sales agreements often include rebates or discounts payable by the seller to its customer. For example, if a customer purchases a certain value of goods, a refund of a specified percentage will be granted. In our view, if it is probable that the rebate or discount will be granted, and the amount can be measured reliably, the rebate or discount is recognised as a reduction of revenue as the sales are recognised (i.e., before the threshold is met).

As an example, an entity sells goods and grants the following rebates, based on sales to each customer during a calendar year, which also is the entity's financial year:

- up to 1,000 units – rebate of one per cent of the sales price
- up to 2,000 units – rebate of two per cent of the sales price
- more than 2,000 units – rebate of three per cent of the sales price

Usually the majority of sales take place in the fourth quarter. The entity concludes that it is probable that it will sell 3,500 units to a particular customer over the full year, reflecting its past experience and current year budgets.

In our view, the percentage used to determine the rebate and therefore the amount of revenue to recognise during the year should reflect the expected sales to the customer for the full year. The same principle is applied when an entity prepares interim financial statements (see 5.9). Therefore, the entity applies a rebate percentage of three per cent to measure revenue during the first quarter, based on the expected sales of 3,500 units for the full period.

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If it is probable that the criteria for the rebate or discount will not be met, or if the amount thereof cannot be estimated reliably, the rebate or discount should not be recognised until the payment is probable and the amount can be estimated reliably. In our view, the rebate or discount should be recognised as a reduction in revenue at the time that the rebate can be estimated.

Early settlement discounts

In our view, if it is probable that the early settlement discount will be taken, and the amount can be measured reliably, the discount is recognised as a reduction of revenue as the sales are recognised. For example, J sells goods on credit to customers and normal credit terms are 60 days. J grants a two per cent discount if customers pay within 10 days of the invoice date. In our view, the settlement discounts and the expected cash flows should be estimated at the time of sale and the expected discount recognised as a reduction of revenue.

In theory, the difference between the discounted amount and the full invoice amount is finance income for all discounts not taken. In practice, when such discounts are not taken, the amount of revenue recognised generally is the higher amount receivable before discount, provided that receipt is not deferred beyond normal credit terms (see below). This approach is consistent with the assumption that there is no financing element when receipt is within normal credit terms.

Deferred payment

IAS 18.11, 39.38, 39.AG 35, 53

In our view, when payment for goods sold or services provided is deferred beyond normal credit terms, and the entity does not charge a market interest rate, the arrangement effectively constitutes a financing arrangement, and interest should be imputed, if the impact is material. In these cases, the amount of revenue recognised on the goods sold or services provided will be less than the amount that ultimately will be received.

When a current cash price is available, the imputed rate of interest is the rate that exactly discounts the amount to be received in future to the current cash sales price. In practice the price for normal credit terms often is treated as the cash price equivalent.

When a current cash sales price is not available, the imputed rate of interest is a market rate for a similar instrument. For example, A sells a car to B for 1,100 and payment is due in 12 months. A will not charge B any interest. Current market interest rates are 10 per cent. The fair value of the consideration, and therefore the revenue recognised on the sale of the car, is 1,000, calculated as the present value of the future payment of 1,100. The difference of 100 should be recognised as interest income over the period of financing, using the effective interest rate method (see 4.6). Because A will receive the revenue only in a year (which is outside normal credit terms), the revenue recognised for the sale transaction is less than the amount that will be received.

The length of normal credit terms will depend on the industry and the economic environment.

4.2.6 Applicability of IAS 11 or IAS 18

Contracts for the manufacture of goods or provision of services may have to be accounted for under IAS 18 as the sale of goods (see 4.2.7) or the provision of services (see 4.2.9), or under IAS 11 when construction contract accounting would apply (see 4.2.8). Under IAS 11, a transaction is accounted for using the stage of completion method and the profit or loss will be recognised based on the appropriate degree of completion. When IAS 18 is applicable, the inventory is accounted for in accordance with IAS 2 (see 3.7).

In determining whether a contract is accounted for using the stage of completion method under IAS 11, the following considerations may be relevant:

- construction contract accounting is applicable not only to the construction of buildings, but also to the construction of other complex assets or pieces of equipment (see below);

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- a construction contract may be for a number of units or a single integrated system;
- a number of criteria must be met before a contract for the sale of assets may be treated as a construction contract; and
- IAS 18 requires the application of the stage of completion method of accounting as described in IAS 11 to some sales of services (see 4.2.9).

Applicability of construction contract accounting

Identifying assets to which construction contract accounting is applied

IAS 11 is intended for more than construction work in the narrow sense of constructing a building. In our view, construction of both complete assets and components that are for use in a larger asset may be accounted for as construction contracts if they are complex custom-designed items. For example, the construction of components of aircraft specifically designed for customers are likely to be construction contracts provided that the general considerations below are met, if the components are complex custom-designed pieces of equipment.

The construction or development of certain intangible assets also may be accounted for using the stage of completion method, for example, the development of custom software and technology products.

IAS 18.21 The stage of completion method in IAS 11 also is applied to transactions involving the rendering of services. Under this method, revenue is recognised in the accounting period in which the services are rendered.

Multiple items or units

A construction contract may deal with the construction of a number of assets that are closely interrelated or interdependent in terms of their design, technology and function or ultimate purpose. A contract also may be for the construction of a system with component parts. A system is a single integrated unit and not just multiple units of a standard product. For example, the sale and installation of a radar system that requires the installation of 100 units, all of which are required in order for the system to work, would, in our view, fall within the definition of a construction contract. However, the sale of 100 radar towers that each operate independently of one another is not a system that would be a single construction contract. Each radar tower may itself be a construction contract if it is considered to be a complex, custom-designed piece of equipment. For further discussion of this topic see *Bulk orders* below.

General considerations for the application of construction contract accounting

In our view, the following criteria should be met in order to account for a contract as a construction contract under IAS 11, rather than a sales contract under IAS 18:

- the parties enter into a binding contract prior to the commencement of construction. The contract is negotiated individually, taking into account the customer's requirements, and is more specific than simply entering into a broad framework agreement;
- items to which the contract relates are constructed specifically for the customer on a customised basis, are individually designed and developed, and are not simply an order to purchase a large number of mass produced items; and
- the contract is enforceable. The cancellation and penalty clauses in the contract are assessed to determine whether these are sufficiently substantive to make the contract enforceable. For example, when a customer could cancel a contract without paying any penalty, in our view, it would be more appropriate to account for these transactions in accordance with IAS 18.

Some entities may have a catalogue of standard models but customers may request certain aspects to be adapted to meet their particular specifications. In our view, in order to be a construction contract, a high degree of specification, unique to the customer, would be required.

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An entity also considers the costs of the individual customer's requirements in proportion to the total costs of the contract. A high amount of customisation with respect to the total cost of the contract would not always be considered to be a construction contract. This might be the case when the modifications made are a combination of minor adjustments to standard equipment or an externally purchased device is attached to the standard equipment.

Revenue from the sale of catalogue items that are available on a standardised basis is accounted for in accordance with IAS 18 (i.e., generally when the item has been delivered and all significant performance obligations have been met). For example, when items (such as cars with certain specifications demanded by the customer) are mass produced and the order was simply for 200 items from a production line, in our view this would not qualify as a construction contract, so long as the degree of customisation is not significant.

Specific application issues for construction contracts

Bulk orders

Sometimes entities receive orders to manufacture numerous items of a particular custom design. In these cases, the entity considers:

- whether the construction of the assets produced under the contract would qualify as a construction contract; and
- if the assets qualify, and the contract is a construction contract, whether each unit is considered to be a construction contract or the entire order is considered to be one construction contract to manufacture a number of items.

For example, in our view, an order for 100 aircraft should be treated as one overall contract, and construction contract accounting applied, if:

- there is a binding contract for the total order (e.g., 100 aircraft);
- the items ordered are custom-designed, for example, if the items ordered (although based on a standard platform) are modified and tailored to a high degree to the customer's specific needs;
- the penalties, in the event the total order is cancelled (in this case, 100 aircraft) covers at least the costs incurred until the contract is cancelled; and
- all items are negotiated and total consideration is determined as part of a complete package (see 4.2.3).

Learning curve costs

"Learning curve" costs are common in contracts for multiple units of a custom-designed item. Losses may be incurred on the manufacture of the earlier units, while later production is more profitable as a result of construction efficiencies.

In our view, when the contract is within the scope of IAS 11 and is considered to be a single contract to manufacture numerous units, the learning curve costs are costs that relate to future contract activity and therefore are recognised evenly over the period of the contract under which these costs are expected to be recovered. As a result the learning curve costs are allocated evenly to each unit in the contract. When the contract is considered to be a construction contract, but firm orders have been received only for a portion of the units, the learning curve costs are spread only over those units for which a firm order has been received.

In our view, if the contract for 100 aircraft in the example above is treated as a single construction contract, the learning curve costs incurred in producing the earlier aircraft is spread evenly over the entire contract. If IAS 18 was applied, losses might be recognised on the sale of the earlier units while later production would be more profitable, once efficiencies in the construction process were achieved.

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Recurring and non-recurring costs

In some cases, entities may enter into long-term programmes for the development and manufacture of components or assets. These long-term programmes may not meet the definition of construction contracts, as the criteria discussed above may not be met. These programmes often are divided into the multiple phases including:

- Non-recurring phase – period during which the design, development and production preparation activities are performed. During this phase, production orders may not have been received.
- Recurring phase – period during which the components and assets are manufactured, either per shipsets (working packages that are technically defined) or in small series of several shipsets, depending on the specification of the agreed purchase orders.

The entity considers whether any part of the agreement is a construction contract and therefore is accounted for under IAS 11. In some cases, a general agreement (framework) is negotiated with the customer, which covers both the non-recurring phase and the recurring phase and, under this framework, the contractor usually is compensated for non-recurring activities during the recurring phase, because the price per item includes compensation for the non-recurring costs. However, the customer may not be obliged to purchase a specified quantity and therefore no construction contract exists in respect of the full programme.

The agreement with regards to the non-recurring phase may or may not be a construction contract under IAS 11. If it is a construction contract, the costs of the non-recurring phase are treated as contract costs and the costs and related revenue are recognised in accordance with IAS 11. If there is no binding agreement for the recovery of the costs of the non-recurring phase or other indicators for a construction contract are not present, the costs incurred during the non-recurring phase are capitalised and deferred only if they qualify for capitalisation as an intangible asset under IAS 38 (see 3.3).

During the recurring phase, there still may be uncertainty regarding the quantity of items to be sold. A binding sales agreement (and therefore potentially a construction contract) is created only once a firm purchase order exists. Therefore, revenue recognition is based on the agreed number of firm purchase orders. If the non-recurring costs were recognised as an intangible asset, the intangible asset would be amortised and included in construction work-in-progress inventory. However, treatment as a construction contract is subject to the existence of the additional requirements discussed above.

Even if the order will be accounted for as a construction contract, the results of the first purchase orders (contract) still may be a loss. This is because start-up costs or high (inefficient) production costs, not eligible for deferral, may be incurred that must be written off as incurred.

Real estate development

Some contracts for the sale of residential properties may appear similar to construction contracts when the contract is signed before the construction of the building is complete. For example, the contract may relate to a specific asset and the customer may make progress payments during construction. In our view, such pre-completion contracts will meet the definition of construction contracts if:

- contracts are negotiated specifically with the customers prior to commencement of construction. This condition will not be met when the development company commences construction of the units prior to putting in place specific sales contracts for the sale of individual residences;
- the specification of the assets (e.g., apartments) is negotiated specifically with the customer. In general, a construction contract is a contract whereby the asset is constructed specifically for the customer on a customised basis. Some pre-completion contracts may specify a degree of

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customisation of the apartments (e.g., paint, appliances, fittings), but if this is small in relation to the project as a whole it is not a construction contract. For example, an "off the shelf" house design under which cosmetic details and optional extras may be specified by the customer is not, in our view, sufficient customisation to fall within construction contract accounting; and
- customers may not cancel the contracts without significant penalty.

When these conditions are not met, the construction of an apartment building and the sale of individual apartments within that building are considered to be separate events. Accordingly, the sale of the units would be accounted for under IAS 18, which has a number of criteria for revenue recognition on the sale of real estate (see 4.2.7).

Another typical issue is when a real estate developer forms a mutual company or fund to develop the property and perform the subsequent administration thereof. During development, or once it is complete, the developer sells shares in the fund or entity rather than title to the underlying property. Often the shares in the mutual company or fund are sold only once development has commenced; the shares issued can be sold freely on the secondary market.

In our view, these arrangements often are similar to the development and subsequent sale of a property, even though, in these cases, the developer is selling units in the fund that owns the property, rather than the property itself. We believe that even if the developer has a "construction contract" with the legal entity created to own the property, the developer should not account for the project as a construction contract. The developer should recognise revenue for the sold apartments (demonstrated by the sale of the shares to the investors) only when the construction of the apartments has been completed.

Similarly, an entity may enter into contracts to construct buildings, semi-industrial warehouses and / or offices and sell its interest in the property to a third party, for example, a real estate fund, once a reasonable occupancy rate of the premises has been achieved. In some cases the occupancy rate is achieved (and thus the project sold) before actual construction commences through pre-construction leasing.

In our view, the revenue-generating activity of the entity is selling properties, both in progress and completed. In most cases, the construction contracts are not specifically negotiated with the ultimate buyer, and construction often commences before a sales agreement or contract is negotiated. Work-in-progress and production costs should be recognised as inventory (see 3.7). Recognition of the revenue for the sale of the project will be in accordance with IAS 18. Accordingly, the entity should recognise revenue at time of sale or completion, whichever is later, provided that the other criteria in IAS 18 have been met.

The same analysis should be applied if the developer in the example above sold shares in the fund before construction has been completed.

4.2.7 Sale of goods

IAS 18.14 In addition to the general recognition tests (see 4.2.4), the following criteria also must be met for sale of goods before revenue can be recognised:

- there is no continuing managerial involvement over the goods to the degree usually associated with ownership; and
- the significant risks and rewards of ownership of the goods have been transferred to the buyer and there is no effective control over the goods.

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IAS 18.14-17

In most cases transfer of the significant risks and rewards of ownership will correspond to the transfer of legal title or physical delivery for retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

In evaluating the point at which the risks and rewards of ownership transfer from the seller to the buyer, one of the considerations is the shipment terms. Standard trade definitions that frequently are used in international purchase and sales contracts are FOB (Free on Board), CIF (Cost, Insurance Freight) and DDU (Delivered Duty Unpaid) (see 3.7).

Generally, in the case of FOB and CIF, the significant risks and rewards of ownership are transferred to the buyer when the goods are loaded onto the ship, or other delivery vehicle, at the port of the seller. In the case of DDU the significant risks and rewards of ownership are transferred to the buyer when the goods are delivered to the port of the buyer. The sale is recognised when these events occur, provided that the other conditions contained in IAS 18 have been met.

Managerial involvement and effective control

IAS 18.14

In order to recognise revenue the seller should not maintain effective control over, or managerial involvement to the extent normally associated with ownership of, the goods. These criteria are especially important in analysing non-standard transactions, for example bill and hold sales, when delivery is delayed at the buyer's request, but the buyer takes title and accepts billing.

IAS 18.A1

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery. For bill and hold transactions revenue is recognised when the customer takes title, provided:

- it is probable that delivery will be made;
- the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
- the buyer specifically acknowledges the deferred delivery instructions; and
- the usual payment terms apply.

For example, A offers customers financial incentives to place purchase orders before they actually need the goods. A offers to hold the goods for the customers until they request delivery, as customers cannot store the out-of-season merchandise. In most cases A pays the cost of storage, shipment and insurance on the goods.

In our view, A should not recognise the revenue prior to delivery, since the buyer simply takes advantage of the inducements offered and delivery is not delayed at the buyer's request. The entire transaction was initiated by A. A pays for the cost of storage, shipment and insurance on the goods, and in our view the significant risks and rewards have not passed to the buyers.

Consideration of the "usual payment terms" often will depend on historical evidence of how such sales are transacted normally. If there is no precedent for such a sale and the terms of payment appear abnormal, this may indicate that revenue should not be recognised.

Consideration of risks and rewards of ownership

Some guidance on the significance of risks and rewards transferred is provided below.

Significant performance obligations

IAS 18.16, 18.A2(a)

Revenue is recognised once all significant performance obligations have been met. For example, when goods are subject to installation or inspection (and that is a significant part of the contract) revenue is recognised once the installation or inspection is complete.

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As an example, an entity manufactures, sells and installs complex machinery for customers and the complete package costs 20,000. In our view, when the entity agrees to carry out the installation as well as the supply of goods, revenue should not be recognised until installation is complete. The customer cannot use the machinery until it is installed, and therefore the significant risks and rewards of ownership have not passed.

However, a manufacturer may enter into two separate and distinct performance obligations with a customer (one for the machinery and one for installation). In this example, the installation is routine and could be performed by the customer or another third party. Therefore, in this case, the risks and rewards of ownership of the machinery have passed upon delivery and the revenue related to the delivery of the machinery should be recognised.

Warranty obligations

IAS 18.16

Granting a typical guarantee or warranty (see 3.11) normally does not result in the retention of significant risks by the seller and, consequently, would not preclude recognition of revenue. However, an abnormal warranty obligation may indicate that the significant risks and rewards of ownership have not been passed to the buyer, or that the seller has not performed all of its obligations in delivering a product that the buyer can use.

Right of return by the buyer

IAS 18.16, 18A.2(b)

When the buyer has a right of return and there is uncertainty about the possibility of return, revenue is not recognised until the shipment has been accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed.

In our view, an entity considers historical experience in assessing the possibility of return. If, based on past experience, the entity can make a reliable estimate of the amount of goods that will be returned, it would be appropriate to recognise revenue for the amount that is expected to be received (assuming that the other conditions of IAS 18 are met).

Receipt of revenue from a sale is contingent on a sale by the buyer (sell-through arrangements)

IAS 18.16, 18.A2(c)

In some cases, the receipt of revenue by an entity is contingent on the buyer making a sale of the goods. Examples include situations when inventory has been transferred to another entity (a consignee) who holds it on consignment at its premises, or when sales are made to distributors or other parties acting as agents. Revenue is recognised only when the inventory has been sold by the consignee to third party buyers.

Repurchase options

IAS 18.A5

At the time of the sale, a seller may enter into an agreement to repurchase the same goods at a later date or the seller may have an option to repurchase the goods at a later date. An entity also may provide a guarantee to pay the customer any shortfall between the residual value of an item, for example, a car, at a certain point in the future and a guaranteed amount. Such transactions are considered to be linked (see 4.2.3). When the seller enters into a sale and repurchase agreement, the terms of the agreement need to be analysed to determine whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer.

If the overall effect of the agreements is that the seller has not transferred the risks and rewards of ownership of the asset, the transaction is considered to be a financing arrangement and no revenue is recognised with respect to the initial "sale".

If the buyer is required to sell a similar asset back to the seller at the end of the buy-back period, the assessment of the transfer of risks and rewards would be evaluated in the same manner as discussed below.

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General guidance
In our view, it is appropriate to consider the guidance for lease accounting to determine whether risks and rewards have been transferred and a sale should be recognised (see 5.1), if the seller has a repurchase option or obligation. Under IFRSs finance leases are distinguished from operating leases based on the extent to which risks and rewards of ownership are transferred to a lessee.

In our experience, the following are factors that may indicate that the seller has transferred substantially all of the risks and rewards of ownership to the buyer even if a repurchase right or obligation is retained:

- the period from sale to repurchase is for the major part of the economic life of the asset;
- the difference between the proceeds received on the initial transfer and the amount of any residual value guarantee or repurchase price, measured on a present value basis, amounts to substantially all of the fair value of the asset at the sale date;
- insurance risk is borne by the buyer. However, if the buyer bears the insurance risk but the seller bears the remaining risks, in our view, the risks and rewards probably have not transferred to the buyer; and
- the repurchase price is equal to the market value at time of buy-back.

Residual value guarantees
A seller may offer a guaranteed residual or reimbursement to the buyer. In our view, a guaranteed residual amount (measured on a present value basis) in excess of approximately 10 per cent of the initial sales price of the goods would not qualify as an "insignificant" ownership risk. When the guaranteed repurchase price or residual value guarantee will be determined using a formula or model, in our view, the entity should estimate the residual value guarantee at the date of the transaction based on the *expected* amount of the residual value.

Evaluating the significance of a residual value guarantee also should consider the seniority of the guarantee. For example, if the guarantee is for a small percentage of the expected residual value and it is a "last loss guarantee", then the expected value will be very low, because substantially all of the estimated residual value would have to be lost before the guarantee takes effect.

If the seller transfers the significant risks and rewards of ownership to the buyer then the transaction is a sale and the related revenue recognised (provided that other conditions also are met). Under IFRSs, liabilities are not recognised in respect of commitments to purchase assets (as these are executory contracts). Any call and put option will be outside of the scope of the financial instruments standards if physical settlement is required (see 3.6). However, a provision for an onerous contract may be required (see 3.11).

IAS 18.A5 If the significant risks and rewards of ownership remain with the seller, the transaction is not a sale and no revenue is recognised. The transaction is, in substance, a financing arrangement. Therefore, the lease accounting standard is likely to apply because it covers asset-specific financing when the use of the asset is granted to another party (see 5.1). In these cases, the characteristics of the transaction suggest that the seller acts as a lessor in an operating lease for the period between the legal sale and the repurchase date. The fact that the "buyer" pays for the goods or that title transfers is not conclusive if the substance of the transaction is a financing agreement.

As an example, K sells equipment to its customers and agrees to repurchase the equipment after three years at its market value, which will reflect market conditions at that point, and the extent of use and condition of the equipment. Customers pay the full purchase price at the sale date and there are no restrictions on the extent to which they can use the asset, and no requirements in relation to its general upkeep and maintenance. Comparable second-hand equipment is freely available in a liquid market (i.e., it is not specialised).

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In our view, K recognises revenue on the sale because the risks and rewards of ownership, including residual value risk, have been transferred to the customer. The only obligation of K is to buy back the equipment at its market value.

In an alternative arrangement, the customer settles the purchase price by 36 equal monthly instalments and K agrees to repurchase the equipment after three years at a specified price, which results in it obtaining a lender's return from the overall arrangement. The customer is required to maintain the equipment to a specified level, and restrictions are placed on use of the asset. If the customer defaults on its payments, K has the right to repossess the equipment.

In our view, the substance of the transaction is that of a secured borrowing and consequently no sale is recognised. The sale and repurchase agreement are considered to be linked (see 4.2.3). While the benefits and risks arising from the use of the asset over the three-year period are transferred to the customer, K retains some effective control over the equipment via the restriction of use placed on the customer as well as the residual value risk. For example, if the market value of the equipment at the date of repurchase is less than the residual capital amount outstanding, K has no recourse to the customer (equally, if the residual value is greater than the residual amount K retains that benefit). Further, K obtains a lender's return from the transaction and no more.

K should consider whether the arrangement falls within the scope of the lease accounting standard (see 5.1), as it may be appropriate to account for the equipment as being subject to a lease. If the transaction is a lease, K recognises the payments received over the lease term.

Layaway sales

IAS 18.A3 Revenue from layaway sales generally is recognised when the goods are delivered to the customer.

As an example, R is a retailer that offers layaway sales to its customers. R retains the merchandise, segregating it from items for sale, and collects a cash deposit from the customer. R does not require the customer to enter into an instalment agreement or other fixed payment commitments when the initial deposit is received, however, R sets a time period within which the customer must finalise the purchase. The merchandise is not delivered to the customer until the customer pays the full purchase price. In the event that the customer fails to pay the remaining purchase price, the customer forfeits the amount paid and R, under the laws of its jurisdiction, is allowed to keep these forfeited funds. In the event the merchandise is lost, damaged, or destroyed, R either must refund the amounts paid by the customer or provide replacement merchandise.

R generally will recognise revenue from such sales only when the merchandise is released to the customer. However, when experience indicates that most of these sales are consummated, revenue may be recognised when a significant deposit is received, provided that the goods are on hand, identified and ready for delivery to the buyer. "Significant" is not defined in IFRSs, but in our view the deposit should be large enough to conclude that the particular sale is virtually certain to be finalised, having regard to the entity's past history.

This requirement should be applied to individual sales when the deposit received is significant, not as a general threshold for recognising layaway sales. For example, a fashion retailer requires a five per cent deposit on all layaway sales and experience shows that 95 per cent of the sales are consummated. In this case revenue should not be recognised as the size of the deposit is not significant. However, if on one such sale a significant deposit as has been received, the criteria to recognise revenue may be met.

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Additional examples of risks and rewards of ownership

Non-refundable payment before delivery

A grants a licence to B for a non-refundable fee of 2,000,000 that is paid to A at inception of the arrangement. This licence allows B to sell A's software to third parties and B's initial 2,000,000 of purchases will be offset against the licence fee. B may make further purchases without renewing the licence, once software with a cumulative sales value of 2,000,000 has been sold by A to B. The price of the individual software items is not fixed at the inception of the arrangement.

A is required to make upgrades to existing products and new products available to B as and when they become available. All copies of the software are supplied to B as required.

B has an unlimited right of return for products that it has acquired from A but has not yet sold on to its own customers. The software is for a new market, and the level of potential returns cannot be estimated reliably.

In considering whether the 2,000,000 can be recognised as revenue by A on receipt, A concludes that the amount of the revenue can be measured reliably and it is probable that economic benefits associated with the revenue will flow to A, as the payment is non-refundable and paid in advance.

However, in our view, although the transaction has been described as granting a licence, the substance of the arrangement is that the arrangement is a prepayment for the supply of software by A to B. The purchase price of future software supplies will be set off against the 2,000,000 payment until the value of B's purchases exceed this amount. It is only at that point that B will need to pay for any further supplies.

In our view, A should recognise revenue only when copies of the software are sold by B to end users. A retains the risks and rewards of ownership of the software until it is sold to the end users, indicated by the following:

- at inception A has not performed any of the activities that it is required to carry out under the terms of the agreement (i.e., supply the software). As the goods will be subject to upgrades and new products may be developed, it is not clear what the goods will be;
- B has an unlimited right of return until the point at which it makes a sale to one of its own customers. As the software is designed for a new market, the level of returns cannot be estimated reliably;
- the software prices are not fixed at inception of the contract; and
- copies of the software are delivered individually as B sells them to its end users.

Pre-production costs related to supply agreements

In some cases, an entity may manufacture a product, which is to be used only for manufacturing a certain component for a customer (e.g., a mould). Even if the mould is not sold directly to the customer, the cost of production of the mould often will be recovered from the customer. In these cases, the entity considers whether it in fact retains the risks and rewards of ownership of the mould.

As an example, M manufactures a plastic component for a motor vehicle manufacturer, P. M is obliged to construct the mould in accordance with the detailed specifications provided by P. The costs for the production of the mould form a substantial part of the production cost of the component. P agrees to compensate M for the cost of the mould, either through the price of individual components of the units, or via an up-front payment. Upon acceptance of the mould by P, legal title transfers to it.

When the mould costs are recovered through unit sales, and P fails to purchase the agreed number of components, P is required to reimburse M for the remaining mould production costs. If M fails to deliver ordered items under the supply contract, it still will be entitled to claim the cost of the mould from P, but may be liable for further damages and claims.

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In our view, the agreement between M and P consists of two contracts that are integrated in a single agreement (i.e., construction of the mould and the subsequent delivery of the components that are produced using the mould). The two components should be accounted for as separate agreements.

In our view, while M retains physical control over the mould, the following indicates that the risks and rewards of ownership of the mould are transferred to P at the time that P approves the mould:

- M does not bear the risk of future changes in value of the mould as it is entitled to recover the full cost of production of the mould from P, regardless of the number of parts actually ordered by P;
- M is not exposed to the risk of the mould being idle as a result of reduced needs of P, as it will be entitled to claim any unrecovered mould costs from P. The reimbursement of the costs to manufacture the mould does not depend on M's performance in the delivery phase of the contract;
- the fact that M may be required to insure the mould does not necessarily indicate that it actually bears the risk of loss of the mould (which would be indicative of its economic ownership). This may be a practical issue as it has physical custody of the mould; and
- while M continues to use the mould to manufacture the components, M retains no continuing managerial ownership or control usually associated with ownership. M is not able to use the mould to manufacture components for other customers or for any other purpose; nor may it sell the mould. Further, M may not increase or reduce the capacity of the mould. M is able only to use the mould to fulfil its obligations under the delivery contract.

In our view, to the extent that the other recognition criteria are met, M should recognise revenue on acceptance of the mould by P.

In our view, if the reimbursement for the costs of the mould was dependent on the performance of M and M was not unconditionally entitled to recover the production costs of the mould, the two components of the transaction would be economically integrated and could not be accounted for separately. This would be the case if, for example, M recovered the cost of production of the mould through subsequent orders of items produced using the mould and when M would not recover the costs if it did not deliver the components or if the customer did not order the anticipated quantity. In this case M retains the significant risks of ownership, as it is not contractually able to recover its costs if it does not perform or if P no longer requires the components.

The contracts also would be considered integrated, and accounted for as a single contract, if the revenue attributed to the sale of the mould were far below or in excess of its fair value, with a resulting adjustment to the selling price of the components produced. If the contracts are considered to be integrated, and the mould is considered to be an asset of M, then it may be necessary to recognise a portion of the consideration as a lease payment for the mould.

Sales of real estate

IAS 18.A9 Revenue from sales of real estate in the ordinary course of business generally is recognised when legal title is transferred to the buyer, as normally this demonstrates the transfer of the risks and rewards of ownership of the property. However, in some circumstances the equitable interest in a property may vest in the buyer before legal title passes and the risks and rewards of ownership are considered to have been transferred at this stage.

Continuing involvement

IAS 18A.9 When the seller is required to perform any significant acts after the transfer, revenue is recognised only once those acts have been performed. This may be the case when a seller still is required to complete construction.

In some cases, the property may be sold with a degree of continuing involvement by the seller such that risks and rewards of ownership have not passed to the buyer, for example, sale and repurchase agreements (see above under *Repurchase options*), or a guarantee by the seller of a minimum return or occupancy level. The nature and extent of the seller's continuing involvement determines how the

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transaction is accounted for. For example, significant seller financing may raise questions about the buyer's commitment to the purchase and therefore about the appropriateness of revenue recognition.

In our view, when the seller retains continuing involvement in the property, or provides guarantees of returns and occupancy levels, the guidance in the lease accounting standard is applied in evaluating whether the seller has transferred the risks and rewards of ownership to the buyer (see 5.1).

Sale and leaseback transactions

In our view, when an entity enters into a sale and leaseback transaction, the seller considers both the sale and the leaseback transactions to determine whether it has transferred substantially all of the risks and rewards of ownership of the asset, as discussed above. When it does not transfer substantially all of the risks and rewards of ownership, the sale is recognised and the leaseback considered to be a finance leaseback, otherwise the leaseback is treated as an operating leaseback (see 5.1). We believe that the net transaction does not have to satisfy all of the revenue recognition requirements in IAS 18 because the leaseback results in the transaction falling within the scope of IAS 17.

IAS 40.67 IAS 18 also is applied to disposals of investment property to determine the date of disposal (see 3.4). However, the lease accounting standard (IAS 17) applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

4.2.8 Construction contracts

IAS 11.3 Construction contracts are classified either as fixed price contracts or as cost plus contracts.

Revenue for cost plus contracts is recognised when the general revenue recognition requirements are met (see 4.2.4).

IAS 11.23 In addition to the general revenue recognition criteria (see 4.2.4), the following criteria also must be met for fixed price construction contracts:

- the outcome of the contract can be estimated reliably; and
- the stage of completion of the contract can be measured reliably.

IAS 11.22 Once the revenue recognition criteria are satisfied, both contract revenue and contract costs of both fixed price and cost plus construction contracts are recognised by reference to the stage of completion of the contract. The completed contract method is not permitted. Any costs incurred or consideration received in excess of the stage of completion generally are deferred.

IAS 11.32 When the outcome of a construction contract cannot be estimated reliably, no profit is recognised, but revenue is recognised to the extent of costs incurred that are probable of recovery. Costs are recognised as an expense as incurred.

Recognition of contract revenue and expenses

IAS 11.25-27 Contract revenue and expenses are recognised in accordance with the stage of completion of the contract. Under the stage of completion method, contract costs, revenue and the resulting profit are recognised in the period that the work is performed. Contract costs incurred that relate to future activities are deferred and recognised as inventory.

IAS 11.42 For construction contracts in progress, a single asset or liability is presented for the total of costs incurred and recognised profits, net of progress payments and recognised losses, in the balance sheet. There is no guidance on the presentation of the asset or liability related to construction contracts in progress. In our view, it is preferable to present the asset as an accounts receivable, or in the case of a liability, as deferred revenue.

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Contract revenue

IAS 11.11, 12

Contract revenue comprises:

- the initial amount of revenue agreed in the contract; and
- variations in contract work, claims and incentive payments, to the extent that it is probable that these will result in revenue and the additional revenue is reliably measurable.

Revenue measurements are based on estimates that are revised as events and uncertainties are resolved. Amounts may increase or decrease based on variations to the original contract, penalties on delays, cost escalation clauses and other similar items.

IAS 11.12(c) Any penalty for late delivery is a reduction to contract revenue and is accounted for under IAS 11, rather than as a provision or contingent liability (see 3.11 and 3.13 respectively).

IAS 11.12 Revenue is recognised at the fair value of the amount receivable.

IAS 11.41 "Retentions" are common in the construction industry. Retentions usually are determined as a fixed percentage of the total contract price that is paid only once a specified time period has elapsed from the date of completion of the contract and all defects have been corrected. When revenue on a contract is recognised, but will be received only after the expiry of a specified period of time, for example, in the case of a retention, in our view, interest should be imputed and the expected cash receipts discounted to determine the fair value of the amount receivable (see 4.2.5).

Contract costs

IAS 11.16, 21 Contract costs include the costs attributable to a contract from the date of securing the contract to the final completion of the contract. Contract costs comprise:

- costs that relate directly to the contract, for example, labour, materials, direct design and assistance, cost of rectification and guarantee work, royalties paid for the use of intellectual property and depreciation of property, plant, and equipment used directly on the contract;
- costs that are attributable to contract activity in general, for example, insurance and overheads, and that can be allocated to the contract on a systematic and rational basis based on normal contract activity; and
- other costs that are chargeable specifically to the customer, for example, general administrative and development costs that are reimbursed under the terms of the contract.

General and administration costs should be treated as contract costs if the costs relate directly to either performance under a specific contract in progress or the seller's contracting activities.

IAS 11.18 Construction contract projects often are financed by advances from customers. Otherwise long-term funding may be required. Borrowing costs should be included in contract costs when the allowed alternative treatment of capitalisation of interest is applied by the entity (see 4.6).

IAS 11.21 A contractor may incur costs prior to securing the contract, including costs for assigned tenders and tenders that are not yet awarded. Examples of these costs include sales costs attributable to a particular tender presentation, and legal and consultancy fees that can be attributed to a specific contract.

Costs that are related directly to securing a contract and other pre-contract costs are included as part of contract costs only when it is probable that the contract will be obtained and the costs can be identified separately and measured reliably. These direct costs are not presented separately as intangible assets, but rather as amounts due to or from contract customers.

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If pre-contract costs are expensed in the period in which they were incurred, they are not subsequently reinstated as contract costs when the contract is obtained.

IAS 11.20 Costs that cannot be allocated directly to contracts or attributed to contract activity include selling costs, general administrative costs and other costs that are not reimbursable under the terms of specific contracts. For example, in negotiating a contract to construct a plant for the government of country X, an entity agrees to move a portion of its production facilities of an unrelated product to country X. In our view, even though the costs to move the plant are incurred in order to secure a particular contract, they do not relate directly to that contract and should be recognised separately and not as a contract cost.

Stage of completion

IAS 11.30 No specific method is mandated for assessing the stage of completion. An entity may use the more appropriate of input measures (consideration of the efforts devoted to a contract), or output measures (consideration of the results achieved). The following are three different methods that can be used to determine the stage of completion, depending on the nature of the contract:

- surveys of work performed (output measure);
- completion of a physical proportion of the contract work (output measure); or
- percentage of contract costs incurred in relation to total estimated contract costs (input measure).

An example of an output measure is when 60 miles of a 300-mile railway track have been completed: the contract is 20 per cent complete (assuming each mile is equivalent). As an example of an input measure, if estimated contract costs total 2,000 and 800 of costs have been incurred to date, the contract is 40 per cent complete.

IAS 11.31 In our view, output measures are the more appropriate measure of stage of completion as long as a reliable measure of output can be established. For example, a contract may require technical inspections at various stages, which are considered to be identifiable milestones, and the relative values of those milestones can be established. In our view, an input method should be used only if a reliable output measure cannot be established. If an input is used, only those contract costs that reflect the work performed to date should be included in determining the stage of completion, and advance payments made to suppliers should be excluded.

IAS 11.30 Progress billings often are not an appropriate measure of revenue recognition, as revenue recognition should reflect the actual stage of completion, while billing schedules do not necessarily reflect the actual status of the work.

Expected contract losses

IAS 11.36 When it is probable that the total contract costs will exceed contract revenue, the expected loss is recognised as an expense immediately. Expected losses are determined by reference to the latest estimates of contract revenue, contract costs and contract outcome.

4.2.9 Service contracts

IAS 18.21 Service contracts generally are accounted for in the same way as construction contracts (see 4.2.8) and the requirements of IAS 11 are applied to determine the stage of completion for recognising revenue. This includes applying the requirements of IAS 11 for combining and segmenting contracts. The appendix to IAS 18 includes examples of when service contract revenue is deferred or recognised unevenly (e.g., non-refundable initiation fees). Some of these examples combine or segment service contracts without all the criteria in IAS 11 being satisfied directly. Therefore, both IAS 11 and the guidance in the appendix to IAS 18 must be considered in determining revenue recognition for sales of services.

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Timing

IAS 18.A17, 18.A18 Fees for the provision of continuing services, whether they are part of an initial fee or are charged as a separate fee, are recognised as revenue as the services are rendered. Any initial or entrance fee is recognised as revenue when there is no significant uncertainty as to its collection and the entity has no further obligation to perform.

IAS 18.25 When services are performed through an indefinite number of repetitive acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless some other method better represents the stage of completion. When a specific act is much more significant than any other acts, revenue is recognised only after the significant act is performed.

As an example, A operates an electronic payment processing service on behalf of retailers who accept payment by credit card. One-off costs are incurred by A on inception of the arrangement for adding the retailer to its processing system. Charges to retailers for the service comprise a set-up fee on inception of the arrangement of 360 followed by annual charges of 240 per annum beginning on the first anniversary of the arrangement. A makes a reasonable profit from the ongoing services based on the annual charge of 240.

Although the initial charge of 360 is described as an initial set-up fee, no separate charge is made for the provision of the first year's services. In our view, A should recognise 120 as revenue (360 total minus 240 deferred based on normal annual charges) once a retailer is added to its processing system and the balance of 240 over the first year, being the period during which services are provided or made available. In subsequent years, the annual fee should be recognised as revenue over the service period.

IAS 18.A11, 18.A18 In some cases, an initial fee is levied, followed by, or including, separate fees for services, but the separate fees do not cover the cost of the continuing services together with a reasonable profit. In these cases, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognised as revenue as the services are rendered. In our view, this is consistent with the requirements in IAS 11 to combine separate contracts in such circumstances.

If, in the previous example, the initial fee was 1,200 and subsequent fees were 50 per year which results in the ongoing service being loss making, in our view it would be necessary to defer at least part of the initial fee of 1,200 and recognise it as revenue in future periods.

In our view, the entity may consider market transactions to determine the amount to be deferred. If there are no market transactions, but there is a period during which A expects to provide services to these customers or a period which reasonably can be estimated, we believe that it may be appropriate to spread the additional fee over that expected or estimated period. Alternatively, a realistic maximum potential period may be estimated and revenue recognised over that period.

Supply and service agreements

Supply or service transactions may involve charging a non-refundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services or the ongoing rights or services being provided are essential to the customers receiving the expected benefit of the up-front payment. In these cases, the up-front fee and the continuing performance obligation related to the services to be provided should be assessed as an integrated package (see 4.2.3). In our view, in these circumstances, up-front fees, even if non-refundable, are earned as the services are performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognised systematically over the periods that the fees are earned.

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As an example, U, a biotechnology company, agrees to provide research and development activities to a customer for a specified period of time. The customer needs to use certain technology owned by U. The technology is not sold or licensed separately without the related research and development activities. Under the terms of the arrangement, the customer is required to pay a non-refundable "technology access fee" in addition to periodic payments for research and development activities over the term of the contract.

In our view, the activity completed by U (i.e., enrolling the customer) is not a significant revenue-earning event. The customer is purchasing the ongoing rights, products, or services being provided through U's continuing involvement and the revenue earning process is completed by performing under the terms of the arrangement, not simply by originating a revenue-generating arrangement. This is supported by the fact that U does not sell the initial rights, products, or services separately (i.e., without the company's continuing involvement). The up-front fee should be recognised systematically over the period that the research services are provided since that is the period over which the fees are earned.

The terms, conditions, and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement, and the customer would ascribe a significantly lower, and perhaps no, value to elements apparently associated with the up-front fee in the absence of the company's performance of other contract elements.

Maintenance agreements

A common form of a service agreement is a maintenance agreement, in particular for vehicles. Vehicle maintenance agreements may be provided either on a stand-alone basis, or as part of a vehicle lease or sale contracts. When a service contract is included as part of an equipment sale or lease, the maintenance agreement is separated from the sales or lease agreement.

Revenue for the service contract is recognised during the period in which the maintenance services are performed using the stage of completion method. The amount of the total payment to be deferred is based on the expected cost of performing the service plus a reasonable profit on those services. In our view, this requires estimating when the expected costs under the service contract would be incurred or the services performed, which often is based on previous experience.

Licence fees and royalties

IAS 18.30, 18.A20

Licence fees and royalties are paid for the use of an entity's assets, for example, trademarks, patents, software, music and motion picture films. Fees often are recognised on a straight-line basis.

An entity determines whether the transaction is, in substance, a sale of the asset or rights or is a licensing arrangement. The arrangement would, in substance, be a sale, with revenue recognised on transfer of the rights to the licensee, in the following circumstances:

- the rights to the asset are assigned to the licensee in return for a fixed fee or non-refundable guarantee;
- the contract is non-cancellable;
- the licensee is able to exploit its rights to the asset freely (i.e., the licensor no longer retains managerial control); and
- the licensor has no remaining obligations to perform.

As an example, an entity sells film rights through a distributor who enters into licence agreements with customers. Once the master tape is made available to the distributor and the licence period commences. The entity has no further obligations and has no control over how the distributor distributes the film. In our view, all of the revenue from the sale of the film should be recognised when the licence period begins. Until that time ownership of the rights has not passed.

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In other cases, the proceeds are considered to relate to the right to use the asset over the licence period and the revenue is recognised over that period.

For example, C agrees to distribute films for a film producer. C earns a non-refundable fee of 250,000 up-front, in exchange for a commitment that C would distribute the films. The fee is received before filming commences. C earns a 10 per cent sales commission, but no commission is earned on the first 2,500,000 of sales.

In our view, the two elements of the transactions are linked. The up-front fee is an integral part of the distribution deal because, even if the 10 per cent commission is a market rate, the first 250,000 worth of commission will not be received by C as it has, in substance, been prepaid for these commissions by the up-front fee. Even though the fee is non-refundable, the 250,000 non-refundable fee should be deferred and recognised on the same basis as the commission from distribution.

In some cases, an entity may be entitled to a percentage of the revenues generated by the asset, but will be guaranteed a certain minimum. The guaranteed minimum fee may be recognised in a manner similar to a sale. However, in our view, in most cases it is unlikely that the entity will be able to recognise revenue equal to the guaranteed amount on transfer of the rights. Often the entity still retains significant risks and rewards of ownership because it continues to earn additional revenues based on the performance of the asset.

For example, B grants licences to A to broadcast a number of films on television. B cannot grant the licences to any other party. The licence fee is payable in instalments over a three-year period, based on a percentage of the advertising revenue generated from the films, with a minimum guaranteed fee payable over three years.

In our view, while B receives a minimum guaranteed amount, it still earns a percentage of the advertising revenues earned by A and therefore B still retains risks and rewards of ownership. In this case, revenue does not arise from the initial transfer of the rights to the film, but rather from the use of the films. B will recognise the revenue when the film is shown and the amount of advertising revenue is reliably measurable. If the amount of the recognised revenue from this contract at the end of the term of the agreement is lower than the guaranteed minimum payment, the difference would be recognised as revenue in that period.

Advertising

IAS 18.A12 Revenue for advertising services generally should be recognised only when the related advertisement appears before the public. However, any production commissions are recognised by reference to the stage of completion.

For example, an entity produces, publishes and distributes telephone directories annually, which display advertisements placed by third parties. In our view, the revenue received by the entity from the sales of advertisements will be recognised only when the telephone directories are distributed to the public, despite the fact that the advertisements are arranged and consideration received during prior periods. The related costs are recognised in profit or loss at the same time as the revenue is recognised to the extent that the costs were recognised as inventory (see 3.7). If the directories are delivered over an extended period, for example, over several reporting periods, in our view, it would be appropriate to measure the stage of completion based on the proportion of directories delivered in a period.

Concession arrangements

IFRSs currently do not provide specific guidance on recognition and measurement of concession arrangements, including any fees received from the concession operator. In our view, the concession provider should recognise any guaranteed minimum fee as revenue on a straight-line basis over the concession period, unless another method can be shown to be more appropriate.

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Any fees contingent on the concessionaire's sales or other income should be recognised when earned (i.e., when sales exceed the minimum amount agreed in the concession agreement). This area of IFRSs may be subject to future developments (see 4.2.13).

Financial service and related fees

IAS 18.A14 Financial service fees may be considered an integral part of the effective yield of the instrument (see 4.6); otherwise, they are recognised in accordance with the general requirements as above.

Product financing arrangements

SIC 27 IFRSs do not deal specifically with product financing arrangements, other than those involving the legal form of a lease.

SIC–27 identifies circumstances when a transaction in the form of a lease is not accounted for as a lease. Often these arrangements do not convey the right to use an asset, but may be designed to achieve a tax advantage that is shared with another entity in the form of a fee.

SIC–27 highlights that it is necessary to distinguish between fees earned on the execution of a significant act and fees related to future performance and risks retained. Whether the fee is recognised immediately on entering into the transaction or over the period of the transaction depends on whether or not the fee is contingent on future actions of the entity, including refraining from certain actions.

In our view, there is an initial presumption that any tax benefit received by an entity passed on as a fee is to be recognised over the period covered by the transaction rather than recognised immediately as revenue. In order to recognise any fee immediately, the risk of forfeiture would need to be remote.

In our view, when the entity is exposed to the risk of changes in tax legislation (when part or all of the tax benefit would not be received in the event of a change in tax legislation) it would not be appropriate to recognise the fee immediately.

In some cases, financing also is obtained in addition to the tax benefit or fee. In our view, when this benefit is received in the form of a lower interest rate, it may be appropriate to present the benefit as a reduction in finance charges instead of revenue, provided that the benefit was received in the form of a lower interest rate.

Credit guarantees#

IAS 39.3 When an entity issues a guaranty that meets the definition of a credit derivative, the derivative is measured as a financial instrument in accordance with IAS 39 (see 3.6). On initial recognition an issuer of credit derivatives measures these derivatives at fair value, which usually is equal to the value of the commission received. Subsequently, these instruments are measured at fair value through profit or loss. In the case of a credit derivative that remains out-of-the-money for its term (i.e., the issuer is not required to make payments to the holder) the treatment will have the effect of recognising the commission received as revenue over the term of the credit derivative, though not on a straight-line basis.

When financial guarantees are not credit derivatives under IAS 39 any fee income should be recognised as revenue over the period that the related services are provided (i.e., the period that the guarantee is effective).

For example, a bank grants guarantees (which do not meet the definition of credit derivatives) to its clients for two years and charges a fee that is received on entering into the guarantee transaction. The fee is not repaid to the client if the guarantee is terminated before its expiry date. In our view, the bank recognises the fee as revenue over the two-year period on a basis that reflects the pattern in

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which the related services are provided. If the guarantee period expires early, and the bank has no further obligation, any remaining fee would be recognised as revenue at that point.

Forthcoming requirements

IFRS 4.2, 4(d) IFRS 4 *Insurance Contracts* was issued in March 2004 and provides guidance on accounting for insurance contracts. With the introduction of IFRS 4, financial guarantees that meet the definition of an insurance contract are accounted for under that standard (see 5.10), except for those that an entity enters into or retains on transferring to another party financial assets or financial liabilities within the scope of IAS 39.

IAS 39.3 Other financial guarantees will continue be accounted for under IAS 39.

4.2.10 Software revenue

IFRSs do not provide specific guidance on revenue recognition for software-related transactions.

Often, software sales arrangements provide for sale of the software, together with subsequent servicing or licence arrangements. The substance of the transaction should be considered to determine whether the various components are linked and therefore accounted for as a single contract (see 4.2.3).

The general revenue recognition rules are applied to each component, for example:

- if the software entity is selling software products, the principles for the sale of goods apply (see 4.2.7);
- if the software entity provides services related to software sold (e.g., upgrades or support), revenue from these services should be deferred and recognised when the services are provided (see 4.2.9);
- if the software entity is developing customised software, revenue is recognised by reference to the stage of completion of the development, in a similar manner to services and construction contracts (see 4.2.8);
- when the software entity enters into a licensing arrangement, the revenue is accounted for in accordance with the substance of the licence arrangement (see 4.2.9 – *Licence fees and royalties*).

For example, K develops anti-virus software and sells non-renewable licences for the use of the software. The licensee receives the following during the licence period (which is generally two years):

- use of the software over the period of the licence;
- technical support in case of problems in installing and running the software; and
- an unlimited quantity of updates of the virus database, but not to the software itself.

The various elements of the product (as above) are not sold separately.

Once the licence period ends, users who want to continue using the software are required to pay the full fee again.

In our view, the components of the licence fee are not separately identifiable because no identifiable selling price exists for each of the components and each component of the product is considered to

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be directly interrelated to the others. The software on its own would be useless without the regular virus upgrades. The whole fee should be recognised as revenue over the licence period on a straight-line basis, unless there is another more appropriate method.

In our view, the stage of completion method is not always appropriate for the recognition of revenue for software licences and sales if the sale cannot be separated from any installation or services sold. In many cases the costs to complete the transaction and the direct costs incurred can be measured reliably. However, one of the costs incurred by the entity is that related to the cost of initial development of the software package. This cost would be related to all software and licences sold by the entity and not only to a single package sold to a single customer.

4.2.11 Barter transactions

IAS 18.12 Revenue is recognised by an entity when goods or services are rendered in exchange for dissimilar goods and services. Revenue is measured as the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents received or paid. When goods and services are exchanged for goods or services that are similar in nature and value, the exchange is considered to lack commercial substance and is not treated as a transaction that generates revenue.

See 5.7 for further guidance on non-monetary transactions.

4.2.12 Presentation and disclosure

IAS 1.81 Revenue is presented as a separate line on the face of the income statement.

IAS 18.1, 29 In IAS 18, interest and dividends also are referred to as revenue. In practice, entities other than financial institutions generally present interest and dividends received under the heading "net finance costs" (see 4.6).

IAS 18.35(b), 11.39(a) In addition to the above, revenue arising from the following categories is disclosed separately:

- sale of goods;
- services rendered;
- royalties; and
- construction contracts.

IAS 18.35(c) Revenue from barter transactions is disclosed separately. Revenue also may include rental income earned by a lessor (see 5.1 and 3.4).

IAS 18.35(a), 11.39 Accounting policies adopted for revenue recognition are required to be disclosed, including disclosure of the methods used to determine contract revenue (which will depend on whether contracts are fixed price or cost plus contracts), and the methods used to determine the stage of completion for construction contracts and rendering of services.

SIC 27.10(b) The accounting treatment of fees received on a product financing arrangement is disclosed and also the amount recognised as income during the period. It is likely that these fees will be presented as part of "other operating income", when financing transactions are not considered to be part of the entity's ordinary activities.

4.2.13 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

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Revenue recognition

The IASB, in conjunction with the FASB, currently is developing a new accounting standard on revenue, which eventually will replace IAS 18. The primary objective of this project is to develop a comprehensive set of principles for revenue recognition that will eliminate the inconsistencies in the existing authoritative literature and accepted practice.

Service concession arrangements

IFRIC currently is considering how IFRSs should be applied in accounting for service concessions and similar arrangements.

Construction contracts

IFRIC currently is considering guidance on combining and segmenting of construction contracts. The purpose of the discussions is to:

- provide additional guidance on criteria for combining contracts;
- clarify that it is expected to be rare for a group of contracts with more than one customer to meet the combining criteria; and
- consider whether the guidance in US GAAP is consistent with IFRSs.

Right of use of assets

When revenue is not recognised on a sale transaction (i.e., a "failed sale"), a supplier should consider whether the agreement contains a right to use the asset using the criteria under IFRIC draft interpretation, D3, *Determining Whether an Arrangement Contains a Lease*. Under the draft interpretation a supply arrangement contains an embedded lease when specified criteria are satisfied.

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4.3 Government grants

(IAS 20, IAS 41, SIC–10)

Overview

- **Government grants relating to biological assets are recognised as income when they are unconditionally receivable.**
- **Other government grants are recognised as income so as to match the costs that they are intended to compensate.**

4.3.1 Definitions

IAS 20.3 Government grants are transfers of resources to an entity by a government entity in return for compliance with certain conditions relating to the operating activities of the entity. An example is a government subsidy.

SIC 10 Government assistance meets the definition of a government grant even if the conditions are only a requirement to operate in certain regions or industry sectors.

IAS 20.3, 34-38 IAS 20 establishes accounting requirements only for government assistance in the form of grants. Therefore, the distinction between government grants and other forms of government assistance is important. Government assistance is not considered a government grant if the assistance cannot reasonably have a value placed upon it, or is a transaction with a government body that cannot be distinguished from normal operating transactions of the reporting entity. Therefore, when a government provides free technical or marketing advice or other services or guarantees, the assistance normally is not recognised in the financial statements. Similarly, a government procurement contract, or similar arrangement, whereby a government body agrees to buy certain output produced by an entity, normally is not distinguished from the normal operations of the entity and is not treated as a government grant. The value of government assistance that does not take the form of a grant should, however, be disclosed if it is significant and benefits the entity directly.

Forgivable loans

IAS 20.10 A government may give a loan that will be forgiven if certain conditions are met (a forgivable loan). In our view, a forgivable loan should be treated as a government grant only when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan. Otherwise the loan should be shown as a liability.

For example, A is launching an airline. Government Z provides A with financing to fund the launch. The financing is in the form of a loan that will be repayable by the entity if the business is successful, but the amount advanced will not be repaid if the airline is launched but the business is unsuccessful. In our view, A should recognise the amount received as a liability. The liability would become a government grant (forgivable loan) if, and only if, the venture did not succeed.

Waiver of expenses

In some cases, instead of providing a cash grant, a government may waive amounts payable by the entity (e.g., a liability for taxes). In our view, these qualify as government grants because in substance there is a transfer of resources, although it is in the form of a waiver of expenses.

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4.3.2 Recognition and measurement

IAS 20.7 Government grants are recognised when there is reasonable assurance that the entity will comply with the relevant conditions and the grant will be received.

IAS 20.12 Grants are recognised as income on a systematic basis to match them with the related costs that they are intended to compensate.

Grants that relate to the acquisition of an asset are recognised in income as the asset is depreciated or amortised. These grants may be recognised either as a reduction in the cost of the asset, or as deferred income that is amortised as the related asset is depreciated or amortised (see 4.3.3).

IAS 20.20 A grant that is compensation for expenses or losses already incurred, or for which there are no future related costs, is recognised as income in the period in which it becomes receivable. Therefore, if a government provides an entity with annual grants that do not relate to future costs, the grant in respect of each period is recognised as it becomes receivable.

Non-monetary grants

IAS 20.23 When a government grant is in the form of a non-monetary asset, the asset and grant both usually are recorded at the fair value of the non-monetary asset. Alternatively, the non-monetary asset may be recognised at the nominal amount paid. For example, government X gives Y a property with a fair value of 50,000. Y measures both the property and the grant either at 50,000, or at nominal value, in this case presumably zero. In our view, it is preferable for the asset and the grant to be measured at fair value.

Grants relating to biological assets

IAS 41.34, 35 As an exception to the general recognition principle, an unconditional government grant relating to biological assets that are measured at fair value (see 3.8) is recognised in the income statement when it becomes receivable. If the government grant is conditional, it is recognised in the income statement when the condition is met.

Grants relating to assets measured at fair value

Although IAS 41 contains guidance on accounting for government grants relating to biological assets that are measured at fair value (see above), there is no similar guidance for government grants relating to other assets that are measured at fair value and not depreciated, with changes in fair value recognised in the income statement (e.g., investment property). In our view, the treatment required by IAS 41 should be applied by analogy. Therefore, we believe that a grant should be recognised as income when it becomes receivable, provided that any attached conditions are fulfilled, if the grant relates to an asset measured at fair value.

For example, on 25 January 2004 G acquires a property with a fair value of 450,000 by way of a government grant. G measures investment property at fair value. The fair value of the property at 31 December 2004 is 480,000. There are no conditions attached to the grant. In our view, on 31 December 2004, G should measure the investment property at its fair value of 480,000, and recognise government grant income of 450,000 and a gain on revaluation of the property of 30,000.

In another example the local government grants G land with a value of 100,000, on the condition that G builds low-income houses in order to provide an incentive for the development of the region. These properties were built at a cost of 350,000. The completed project has a fair value of 480,000. In our view G should recognise 100,000 either as deferred income that will be amortised to income or as a reduction in the development costs once construction is completed. In either case, G would recognise income of 130,000 either as a revaluation gain (480,000 - (450,000 - 100,000)) or as a combination of a revaluation gain of 30,000 and government grant income of 100,000.

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Grants in the form of a waiver of expenses

In our view, the normal recognition principles apply to grants in the form of a waiver of expenses. Therefore, income should be recognised on a systematic basis to match the cost that the grant is intended to fund.

For example, if a grant is in the form of a waiver of current taxes payable, and the expenditures that the grant relates to are incurred in the period in which the tax is waived, the benefit of the tax relief should be reflected in that period. If the expenditures will be incurred in a future period the benefit of the tax relief should be deferred in the balance sheet until the expenditures are incurred. Similarly, if the grant relates to the acquisition of an asset then the benefit of the tax relief should be deferred in the balance sheet and recognised in the income statement as the related asset is depreciated.

For guidance on the presentation of grants in the form of a waiver of expenses, see 4.3.3.

Repayment

A government grant may be required to be repaid under certain conditions (e.g., if the actual costs to which the grant relates are lower than anticipated).

If there are conditions that may require repayment it is important to assess, at the time of initial recognition of the grant, the probability of repayment being required. In our view, if it is probable that repayment will be required, then the amount received should not be recognised systematically over the compliance period, as normally is done. Instead, the grant should be treated as a liability.

IAS 20.32

If the amount is recognised as a government grant and subsequently some or all of the amount unexpectedly becomes repayable, then the repayment is accounted for as a change in accounting estimate (see 2.8). In our view, the effect of the change in estimate should be recognised in the period in which the grant becomes repayable (e.g., when the required conditions are not fulfilled). A liability should be recognised for the amount of the repayment. The repayable portion of the credit previously recognised should be reversed as follows:

- the credit may have been shown as deferred income or a credit to an asset, in which case the reversal should be against the appropriate balance sheet line item; or
- the credit may have been recognised as a reduction in depreciation or amortisation of an asset or as income, in which case the reversal should be against the appropriate income statement line item.

Low-interest loans

IAS 20.34-37, 39.43, 39.AG64

IAS 20 does not require interest to be imputed on low-interest or interest-free loans from a government. However, loan liabilities, including loans from governments, are financial instruments within the scope of IAS 39. Therefore, in our view, the requirements of IAS 39 override the relief in IAS 20.

IAS 39 requires loans at below-market rates initially to be measured at their fair value (i.e., the present value of the future cash flows discounted at a market interest rate) and interest to be imputed on the loan in subsequent periods. Any difference between the fair value of the loan on initial recognition and the amount received should be accounted for according to its nature (see 3.6).

In our view, any difference between the amount received from the government and the fair value of the liability represents a government grant. Therefore, the principles in IAS 20 would apply and the income should be recognised on a systematic basis (using the effective interest rate method) over the period of the loan. We do not believe that immediate recognition in the income statement is appropriate. Our rationale for this approach is that, in the event of early repayment, the entity normally would be required to repay the nominal amount of the loan, and forfeit the unamortised grant. Therefore, the entity earns the benefit only as time passes, and not when the loan is granted.

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4.3.3 Presentation and disclosure

Presentation of grants related to assets

IAS 8.13, 20.24

Government grants related to assets may be either deducted from the cost of the asset concerned (net presentation), or recognised separately as deferred income that is amortised over the useful life of the asset (gross presentation). In our view, the option chosen dictates the income statement presentation. If net presentation is used in the balance sheet, depreciation is based on the net carrying amount of the asset. If gross presentation is used, the grant is recognised as operating income and depreciation of the asset is shown separately. Whichever method is chosen should be applied consistently to all government grants related to assets.

We prefer gross presentation, in particular because, if the net approach is applied and the amount of the grant is equal to the cost of the asset, neither the asset, nor any depreciation on the asset, will be presented in the financial statements.

For example, F received a government grant of 200,000 to acquire a tractor. The tractor cost 700,000 and has an estimated useful life of five years. If F presents the grant as a deduction from the cost of the tractor, the asset is shown in the balance sheet at its net cost of 500,000 (700,000 - 200,000). The annual depreciation is 100,000 (500,000/5).

If the grant is presented as deferred income, the tractor is shown at its gross cost of 700,000 and annual depreciation on the tractor is 140,000 (700,000/5). In addition, F presents deferred income of 200,000. Each year, 40,000 (200,000/5) is recognised as other operating income.

In our view, if an entity presents government grants as a deduction from the related asset, but the grant is received before the asset is recognised, the grant should be shown as deferred income until the asset is constructed or acquired. If the grant relates to a building to be constructed on land, the grant may be shown as a deduction from the land until the building is constructed.

The deferred income generally is classified as a non-current liability. The portion that will be recognised as income in the next year (i.e., 40,000 in the example of F above) is shown as a current liability.

Presentation of grants related to income

IAS 8.13, 20.29

There is an option to offset a grant relating to income against the related expenditure, or to include it in other operating income. For example, P receives a government grant of 100,000 to fund research costs of 500,000. P has a choice to present the net research costs of 400,000, or to present the gross research costs of 500,000 and show the grant of 100,000 as other operating income. In our view, whichever method is chosen should be applied consistently. However, we prefer a gross presentation in order to be consistent with the approach applied to presentation of grants related to assets.

Presentation of grants in the form of a waiver of expenses

In our view, either a net or gross approach may be used to present a grant in the form of a waiver of expenses. Therefore, if the grant is in the form of a waiver of taxes, we believe that the benefit of the government grant may be shown in the tax line. Alternatively, the tax line may be grossed up and the benefit may be presented in the income statement in the same way as other government grants (i.e., as operating income, a reduction of the related expense, or a reduction in the carrying amount of the related asset and depreciation on the asset).

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4.3.4 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Convergence

In 2003, the IASB concluded that IAS 20 should be withdrawn and replaced with a new standard. The Board decided to add a "fast track" project to consider revising IAS 20 to require grants to be recognised as income when any conditions are met (consistent with the requirements for grants related to biological assets under IAS 41). An exposure draft is expected in the third quarter of 2004.

Emission rights

IFRIC has issued a draft interpretation on accounting for emission rights. The draft interpretation proposed requiring any difference between the amount paid and the fair value of the rights granted to be accounted for in accordance with IAS 20.

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4.4 Employee benefits
(IAS 19)

Overview

- **Liabilities for employee benefits are recognised on the basis of a legal or constructive obligation.**
- **Liabilities and expenses for employee benefits generally are recognised in the period in which the services are rendered.**
- **A defined contribution plan is a post-employment benefit plan under which the employer pays fixed contributions into a separate entity and has no further obligations. All other post-employment plans are defined benefit plans.**
- **Contributions to a defined contribution plan are expensed as the obligation to make the payments is incurred.**
- **A liability is recognised for an employer's obligation under a defined benefit plan. The liability and expense are measured actuarially using the projected unit credit method.**
- **The fair value of any qualifying plan assets of defined benefit plans (including qualifying insurance policies) are offset against the obligation.**
- **Actuarial gains and losses of defined benefit plans that exceed a "corridor" are required to be recognised over the average remaining working lives of employees in the plan. Faster recognition is allowed.**
- **Liabilities and expenses for vested past service costs under a defined benefit plan are recognised immediately.**
- **Liabilities and expenses for unvested past service costs under a defined benefit plan are recognised over the vesting period.**
- **If a defined benefit plan has assets in excess of the obligation, the amount of any net asset recognised is limited to available future benefits from the plan and unrecognised actuarial losses and past service costs.**
- **The expense for long-term employee benefits is accrued over the service period.**
- **Redundancy costs are not recognised until the redundancy has been communicated to affected employees.**

4.4.1 Short-term employee benefits

IAS 19.7 Short-term employee benefits are those benefits payable within one year after the end of the period in which the services have been rendered, and are accounted for using normal accrual accounting. Benefits payable after that time are long-term employee benefits (see 4.4.18).

Compensated absences

IAS 19.11 An employer accrues the obligation for paid absences if the obligation both relates to employees' past services and it accumulates (i.e., can be carried forward to a future period).

IAS 19.13 A liability should be recognised whether or not the benefits are vesting (i.e., employees are entitled to payment of their unused benefits if they leave). For example, if entitlement to sick pay accumulates

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then it is accrued even if it does not vest (i.e., employees do not get paid for unused sick leave when they leave).

In most cases, an entitlement to maternity or paternity leave is contingent on a future event and does not accumulate. Therefore, these costs are recognised only at the time of the absence. In our view, this applies even if employees must complete a minimum service period before being entitled to the benefit, or if the length of the leave entitlement depends on the period of service.

Similarly, no accrual is recognised for amounts to be paid to employees in future periods on national holidays because the entitlement to pay does not accumulate.

Measurement

IAS 19.14 The amount of the liability is that which the entity expects to pay in respect of the unused entitlement.

The accrual for vacation pay should be based on the number of days' leave at each balance sheet date that employees are entitled to, but have not used, and that can be used (or paid) in future periods.

If the benefits are vesting (e.g., employees will receive payments for unused benefits when they leave), a liability is recognised for the expected payments.

In measuring an obligation for non-vesting benefits, the possibility that employees may leave before they use their entitlement should be taken into account. For example, an entity would recognise a liability for an entitlement to sick leave that can be carried forward to future periods, but that will not be paid for if the employee leaves, to the extent that it expects employees to be ill in the future.

Profit-sharing and bonus plans

IAS 19.17 A provision should be recognised for the expected cost of bonus or profit-sharing plans when an entity has a present legal or constructive obligation and a reliable estimate of the obligation can be made. See 2.9 for guidance on determining whether a liability should be recognised at the balance sheet date.

Measurement

The amount provided is the best estimate of the amount the entity expects to pay.

IAS 19.18 If payment is conditional (e.g., on the employee remaining in service) then the conditions (and the possibility of forfeiture) should be taken into account in measuring the obligation.

Low-interest loans

IAS 19.8 Loans given to employees at lower than market interest rates generally are short-term employee benefits. IFRSs do not address directly how to account for such low-interest employee loans.

IAS 39.43 Loans granted to employees are financial instruments within the scope of IAS 39. Therefore, low-interest loans to employees must be measured at the present value of the anticipated future cash flows (discounted using a market interest rate). In our view, any difference between the fair value of the loan and the amount advanced is an employee benefit within the scope of IAS 19.

In our view, loans to employees at below-market interest rates by an entity that is in the business of making loans, such as a bank, also should be measured initially at fair value.

Determining the fair value of loans to employees will require assumptions to be made regarding employee turnover and, if the loans do not have a fixed maturity, estimated repayment dates. In our view, if expectations about repayment dates or employee turnover change, the calculation should be revised and any adjustment should be treated as a change in estimate (see 2.8).

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If the favourable loan terms are not dependent on continued employment, in our view, there should be a rebuttable presumption that the interest benefit relates to past services, and the cost should be recognised in the income statement immediately. If the benefit relates to services to be rendered in future periods (e.g., if the interest benefit will be forfeited if the employee leaves, or is a bonus for future services), in our view the amount of the discount may be treated as a prepayment and expensed in the period in which the services are rendered. If the services will be rendered more than 12 months into the future, the entire benefit is a long-term benefit (see 4.4.18).

Loans to employees often are related party transactions and disclosure of related party transactions is required (see 5.5).

4.4.2 Scope of post-employment benefits

IAS 19.7 Post-employment benefits include all benefits payable after employment (before or during retirement), for example, pensions, medical benefits after employment and severance payments.

Some plans are established to provide benefits both during and after employment. For example, K has a fund for vacation pay. Any surplus in the fund is used to make pension payments. In our view, a plan that pays benefits both during and after employment should be treated as a long-term employee benefit plan (see 4.4.18) rather than as a post-employment benefit plan.

Constructive obligations

IAS 19.52 Post-employment benefit plans include both formal arrangements and informal arrangements that give rise to *constructive obligations*.

IAS 19.52 Constructive obligations arise when an entity has no realistic alternative but to pay the employee benefits. A constructive obligation may arise from informal past practices or communication with employees. See below on classification, 4.4.5 on actuarial assumptions (benefits) and 3.11 for general guidance on constructive obligations.

4.4.3 Classification as a defined benefit or a defined contribution plan

IAS 19.25 Post-employment plans are classified as either a defined contribution or a defined benefit plan. The classification determines the accounting treatment.

IAS 19.7 A plan is classified as a defined contribution plan if the entity pays fixed contributions into a separate entity and will have no further obligation (legal or constructive) to pay further amounts. All other plans are defined benefit plans.

IAS 19.7, 19.BC5 The classification of employee benefit plans is based on the employer's obligation to make further contributions, rather than on the basis of the benefit to which the employees are entitled.

Employee benefit plans may promise employees a defined benefit, for example, payment of a specified amount or an amount to be determined using a specified formula such as a percentage of average or final salary. In many cases, the employer's current funding obligation (e.g., under local social legislation) is limited to a fixed amount or satisfaction of a funding level that is lower than the estimate prepared in accordance with IFRSs of the present value of the future obligation.

In some cases, it may be difficult to determine whether a plan that has promised specified benefits to employees is a defined benefit or a defined contribution plan for the employer. If the plan bears all the risk of funding shortfalls and members would have to accept reduced benefit levels in the event of a shortfall, the plan is likely to be a defined contribution plan.

However, when a defined benefit promise has been made to employees (either by the employer or by the pension plan), in our view it generally is very difficult for the employer to demonstrate that it does not have a constructive obligation to fund any shortfalls.

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However, an employer may settle a defined benefit promise by arranging for an independent insurance company to assume the actuarial risk and the primary obligation to the employees (see 4.4.10). The employer retains only a contingent obligation to make additional payments if the third party defaults. If the risk of the employer having to make additional payments is remote, in our view, such a plan normally is a defined contribution plan and the employer's potential obligation is a contingent liability that should not be recognised (see 3.13).

Impact of vesting conditions

When a plan contains vesting conditions, there is a potential for the employer to benefit (from refunds or reduced future contributions) if the vesting conditions are not met. In our view, such a plan nevertheless may be classified as a defined contribution plan, as long as the employer bears no downside risk and would not be required to make additional contributions to cover shortfalls.

Severance payments

Severance payments and other amounts payable on termination of employment regardless of the reason for the employee's leaving are post-employment benefits. The normal principles apply to determine whether such plans give rise to defined benefit or defined contribution plans. Often the amount of the payments is based on factors such as the number of years' service or final salary. Therefore, these plans often give rise to a defined benefit plan. The principles set out in 4.4.5 to 4.4.17, including the requirements to discount the obligation and to use the projected unit credit method, apply to any defined benefit arrangements.

Multi-employer plans

IAS 19.7 Multi-employer plans are plans that pool the assets contributed by various entities to provide benefits to employees of more than one entity. In multi-employer plans, benefit levels are not determined based on the identity of the employer.

IAS 19.29 Multi-employer plans are classified and accounted for in the same way as single-employer plans, considering the characteristics of the scheme and the obligation of the employer.

IAS 19.30 If insufficient information is available for a multi-employer defined benefit plan to be accounted for in accordance with the guidelines that follow, it is treated as a defined contribution plan and additional disclosures are required. However, in our view, sufficient information to apply defined benefit accounting often can be obtained with adequate planning.

IAS 19.34 There is no exemption from applying defined benefit accounting for a plan operated for more than one entity in the same group, even in the separate financial statements of the group entity. This area of IFRSs may be subject to future developments (see 4.4.22).

State plans

IAS 19.37 State plans are established by legislation to cover all, or specific groups of, entities and are not operated by the employer.

IAS 19.36, 38 State plans are accounted for in the same way as multi-employer plans. If the employer has an obligation only to pay contributions and has no legal or constructive obligation to pay future benefits, state plans are defined contribution plans. Otherwise they are defined benefit plans.

Generally, there is insufficient information available about state plans to apply defined benefit accounting. Therefore, defined contribution accounting normally is applied to state plans. This area of IFRSs may be subject to future developments (see 4.4.22).

Minimum benefit guarantees

In certain cases a plan that otherwise would be a defined contribution plan contains certain minimum benefit guarantees. For example, the employer may guarantee a minimum return on the

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investment of contributions. In our view, a minimum benefit guarantee causes a plan to be a defined benefit plan. This area of IFRSs may be subject to future developments (see 4.4.22).

4.4.4 Accounting for defined contribution plans

IAS 19.44 The entity accounts for its contributions on an accrual basis.

Prepayments and accruals

An asset or liability may result from advance payments or payments due, respectively, to a defined contribution fund.

Refund of contributions or contribution holidays

In exceptional cases an entity may be entitled to a refund of contributions or to a contribution holiday in respect of a defined contribution plan; for example, if an employee forfeits benefits as a result of failing to meet the required service conditions.

In our view, a refund of contributions or a contribution holiday for past services, which already have been recognised as staff costs, should be recognised as income when it is received or receivable. In our view, a refund that will accrue in future periods for services after the balance sheet date (e.g., in the form of a contribution holiday or a reduction in future contributions) should not be anticipated. Rather, the benefit should be recognised by way of a lower (or no) contribution expense in those future periods.

Refunds or contribution holidays related to a multi-employer plan

In our view, an asset should not be recognised in respect of an anticipated refund of contributions or a contribution holiday for a defined benefit multi-employer plan that is accounted for as a defined contribution plan because insufficient information is available to apply defined benefit accounting. Our reasoning is that the factors that give rise to the exemption (i.e., the inability to obtain sufficient information to calculate the entity's proportionate share) and, therefore, the exemption from recognising an asset or liability still apply. However, the surplus and the implications (i.e., the expected reduction in contributions) should be disclosed.

Vesting conditions and advance contributions

When contributions are made to a defined contribution plan in advance of services being rendered, or when a defined contribution plan has vesting conditions, in our view the contributions should be recorded as a prepayment. The prepayment should be expensed as the employees provide services that entitle them to the benefits. In our view, the allocation over the service period should be based on the plan's benefit formula, in the same way as for a defined benefit plan (see 4.4.5).

For example, Y makes contributions to a defined contribution plan on behalf of its employees. Each employee's vested interest is 100 per cent if employment terminates after age 60; 75 per cent if employment terminates after age 55; and 50 per cent if employment terminates before age 55. Therefore, half of the benefits vest immediately, 25 per cent vest at age 55 and the remainder vest at age 60. For employees younger than 55, an employment cost should be recognised immediately for 50 per cent of the contribution. In our view, the remainder should be recognised initially as a prepayment, and a staff cost should be recognised over the vesting period (i.e., 25 per cent over the period until the employee reaches the age of 55, and the remaining 25 per cent over the period until the employee reaches the age of 60). For employees between the age of 55 and 60, 75 per cent should be recognised immediately and the remainder over the period to age 60. For employees over the age of 60 the entire contribution should be recognised immediately.

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4.4.5 Valuation of defined benefit plan liabilities and assets

IAS 19 establishes requirements regarding the basis of the valuation as well as principles about the actuarial assumptions that should be used in valuing defined benefit plans.

IAS 19.51 Estimates, averages and computational short-cuts may be used only if they provide a reliable approximation of the detailed computations that are required. In our view, computational short cuts may be appropriate in practice when performing a roll forward of a previous valuation (e.g., from valuation date to a subsequent balance sheet date).

Measurement of the obligation

IAS 19.64 The projected unit credit method must be used to determine the present value of the defined benefit obligation. This method involves projecting future salaries and benefits that an employee will be entitled to at the expected leaving date.

IAS 19.67 Benefits are attributed to periods of service in accordance with the plan's benefit formula, unless that formula is back-end loaded, in which case a straight-line attribution is used instead.

For example, F operates a defined benefit plan that provides an annual pension of 1/60 of final salary for each year of service. The expected salary on retirement of employees covered by the plan is 600,000. All the employees are expected to retire in 10 years and have worked for five years to date. After retirement the employees are expected to live for 15 years.

The defined benefit obligation is the present value of the expected payment of 750,000 (5/60 x 600,000 x 15). The employee cost for the period (current service cost) is equal to (1/60 x 600,000 x 15) discounted to its present value, adjusted for the actuarially determined probability of the outcome.

IAS 19.83(a) The measurement of plan liabilities must reflect expected future salaries. Therefore, for average salary plans, the *projected* average salary rather than the current average salary should be used in measuring the liability. Similarly, even if the plan benefits are expressed in terms of current salaries, expected future salaries should be considered.

Actuarial assumptions

IAS 19.72 The actuarial assumptions must represent the entity's best estimates of the future variables and should be unbiased (neither imprudent nor excessively conservative) and mutually compatible (e.g., the economic relationship between increases in salaries and future inflation-linked pension increases should reflect the same expectations).

IAS 19.76, 77 The financial assumptions must be based on the current market expectations of future events (e.g., medical cost inflation), and should be determined in nominal (stated) terms unless real (inflation-adjusted) terms would be more appropriate.

Benefits

IAS 19.83 The calculation must take into account not only the stated plan benefits, but also any constructive obligations (those established by informal practices, which the entity has no realistic alternative but to continue, such as "discretionary" inflationary increases in pensions).

IAS 19.83 Also, the assumptions must take into account estimated future salary increases and must include any future changes in state benefits that affect benefits payable under the plan and for which there is reliable evidence that the change will occur.

Although estimates of early retirements should be made, future redundancies must not be taken into account until the employer is committed to make the redundancies (see 3.11). When the employer becomes committed to the redundancies, the impact on the defined benefit plan may need to be treated as a curtailment (see 4.4.13).

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Discount rate

IAS 19.78 The obligation for estimated future payments is measured on a discounted basis. The obligation is discounted using a high quality corporate bond rate (or a government bond rate when there is an insufficiently deep corporate bond market). The currency and maturity of the bond should match the currency and maturity of the pension obligation.

In our view, "high quality" should be interpreted as equivalent to an AA (Standard & Poor's rating) or Aa2 (Moody's rating) bond.

IAS 19.81 If bonds with a maturity that matches the maturity of the pension obligation are not available, an appropriate discount rate should be estimated by extrapolating interest rates on shorter-term bonds using the yield curve and considering any available evidence about likely longer-term interest rates.

IAS 19B.C31 In our view, the incremental borrowing rate of an entity is not an appropriate rate to use because it reflects the credit quality of the entity.

Expected return on plan assets

IAS 19.106 The expected return on plan assets should reflect the best estimate at the beginning of the period of future market returns on plan assets over the life of the obligation.

In our view, expected rates of return need to be reviewed and revised, if necessary, at each valuation date to reflect changes in anticipated market returns.

The expected return on assets denominated in a foreign currency should take into account the economic environment of the underlying investment. In our view, the expected return in the foreign currency should be translated into the functional (measurement) currency based on applicable forward, rather than spot, exchange rates.

Interaction between measurement of plan assets and obligations

IAS 19.78 The discount rate used to determine the obligation should be the rate on high quality corporate bonds; the expected return on plan assets cannot be used instead.

Similarly, in our view, the obligation in respect of a defined benefit plan that would be a defined contribution plan except for certain guaranteed minimum returns on plan assets, should be determined using the rate on high quality corporate bonds and not the expected return on plan assets.

Timing and frequency of valuations

IAS 19.56, 57 IAS 19 does not mandate the timing or frequency of actuarial valuations. It requires them to be regular enough that the amounts recognised in the financial statements do not differ from those that would be determined at the balance sheet date. Thus a valuation a few months before the balance sheet date is acceptable if it is adjusted for material subsequent events (e.g., market price movements and discount rate changes) up to the balance sheet date.

In our view, asset values should be determined at the annual balance sheet date, even if the valuation is done in advance and the obligation is projected forward, since these values normally are readily determinable. Similarly, the expected return on plan assets should be determined based on the value of the assets at the annual balance sheet date.

For interim financial statements a greater degree of estimation may be appropriate (see 5.9).

Qualifications of a valuer

IAS 19.56 There is no requirement to use a qualified actuary to measure defined benefit obligations. However, in our view, it is necessary to use a qualified actuary to perform the calculations each time the valuation is performed.

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IAS 19.57 There are no prohibitions on related parties performing the valuation. Therefore, for example, a suitably qualified employee of the parent may perform an actuarial valuation on behalf of an associate or subsidiary.

4.4.6 Plan assets of a defined benefit plan

Definition

IAS 19.7 Plan assets comprise:

- assets held by a legally separate *fund*, which:
  - can be used solely to pay or fund employee benefits;
  - are not available to the employer's creditors; and
  - cannot be returned to the entity except as reimbursement for employee benefits paid or when the fund is in surplus; and
- qualifying insurance policies (see 4.4.10).

Restriction on availability

In our view, the restriction on the availability of the assets applies both to claims arising from liquidation or similar court proceedings and from normal operations.

It is important that the protection from claims of other parties to the assets is not overridden by other contracts (e.g., mortgages) or legislation. There should be legal restrictions that prevent the assets from being made available to the entity or its creditors under any circumstances, other than for permitted purposes (as discussed above).

Reimbursement for benefits paid

IAS 19.7(b)(ii) Reimbursement of plan assets to a sponsor must relate to benefits that have been paid. Therefore, in our view, the definition of plan assets is not met if an entity has the ability to receive reimbursement *before* the benefit payments are made.

Financial instruments issued by the reporting entity

Plan assets include transferable financial instruments, including shares, issued by the reporting entity.

IAS 19.103 Plan assets exclude contributions receivable from the employer and other financial instruments issued by the employer and held by the fund that cannot be transferred to third parties (e.g., non-transferable loans by the fund to the employer).

In our view, the requirement for financial instruments to be transferable to qualify as plan assets applies to instruments issued by all entities that are part of the group (parent, intermediate and ultimate parent and subsidiaries), in both separate and consolidated financial statements. We also believe that non-transferable financial instruments of associate and joint ventures in which group entities have invested are not qualifying plan assets.

Measurement

IAS 19.54(d) Plan assets are measured at fair value.

The requirement to measure plan assets at fair value overrides the requirements of other standards. Therefore, in our view, if the plan has a controlling interest in another entity, the investment is measured at fair value, and the underlying entity is not consolidated. Similarly, treasury shares that qualify as plan assets are measured at fair value and not presented as a deduction from equity, which normally is the treatment of treasury shares (see 3.10).

Plan assets may include non-financial assets such as property; in our view, these also are measured at fair value, even if they were transferred to the fund by the employer.

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Presentation of the interest in a fund

IAS 19.BC 68D-68I

The employer offsets plan assets against the related obligation to employees; it does not consolidate the fund that holds the plan assets.

Assets that do not meet the definition of plan assets

In our view, investments held in respect of employee benefit plans that do not meet the definition of plan assets should be accounted for in the same way as other financial assets (see 3.6). If the investments include shares of the entity itself, the normal principles in respect of treasury shares would apply (see 3.10).

4.4.7 Accounting for defined benefit plans

Income statement

IAS 19.61

The total cost of a defined benefit plan is essentially the entire periodic change in the plan liabilities less plan assets, aside from certain changes not recognised fully. The total cost comprises the following:

- current service cost;
- interest cost;
- expected return on plan assets, including any reimbursement right recognised as an asset;
- certain actuarial gains and losses;
- certain past service costs; and
- the effect of any curtailments or settlements.

Current service cost

IAS 19.7

The current service cost is the increase in the present value of the defined benefit obligation attributable to the current period's service.

Interest cost

IAS 19.82

The interest cost is the unwinding of the discount in the present value of the defined benefit obligation. It is determined by multiplying the discount rate at the beginning of the period by the present value of the defined benefit obligation during the period, taking account of any material changes in the obligation. In our view, the obligation at the beginning of the period needs to be adjusted only for significant changes (e.g., significant past service costs, settlements and curtailments).

Expected return on plan assets

IAS 19.7

The expected return on plan assets includes interest, dividends and other income expected to be derived from the plan assets, and expected realised and unrealised gains and losses on changes in their value. Anticipated administration costs and tax payable by the fund are deducted to calculate the expected return.

Actuarial gains and losses

Determination of actuarial gains and losses

IAS 19.7

Actuarial gains and losses arise from differences between the actual and expected outcome in the valuation of the obligation and the assets. Actuarial gains and losses may result from experience adjustments (due to differences between assumptions and what actually occurred) or from changes in assumptions.

To determine actuarial gains and losses, a schedule is prepared of movements in the obligation and the plan assets. The difference between the opening balance, adjusted for expected movements during the period, and the closing balance, represents the cumulative actuarial gains or losses.

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The following example, which assumes there are no actuarial gains or losses at 31 December 2003, illustrates the calculation of the cumulative actuarial gains and losses at 31 December 2004 for W's defined benefit plan:

Plan assets	
Fair value at 31 December 2003 (actual market values at 31 December 2003)	14,000
Expected return (based on actuarial calculation at 1 January 2004; seven per cent x 14,000)	980
Contributions for the period (actual amounts received by the fund)	1,050
Employee benefits paid during the period (actual benefits paid by the fund)	(1,500)
Expected fair value of assets at 31 December 2004	14,530
Actual fair value at 31 December 2004 (based on market values at 31 December 2004)	14,920
Therefore, cumulative actuarial gain on plan assets at 31 December 2004	390

Defined benefit obligation	
Obligation at 31 December 2003 (actual obligation based on actuarial calculation at 31 December 2003)	15,000
Interest cost (based on interest rates and obligation at 1 January 2004; six per cent x 15,000)	900
Current service cost (based on actuarial calculation at 1 January 2004)	800
Employee benefits paid during the period (actual benefits paid by the fund)	(1,500)
Expected obligation at 31 December 2004	15,200
Obligation at 31 December 2004 (actual obligation based on actuarial calculation at 31 December 2004)	17,410
Therefore, cumulative actuarial loss on plan obligations at 31 December 2004	2,210

(The interest cost is based on the obligation at the beginning of the year assuming that there are no material changes during the year.)

Recognition of actuarial gains and losses

IAS 19.92 Actuarial gains and losses are required to be recognised when the cumulative unrecognised amount thereof at the *beginning of the period* exceeds a "corridor". The corridor is 10 per cent of the greater of the present value of the obligation and the fair value of the assets. The corridor is calculated separately for each plan.

In the above example, the corridor at 31 December 2004, used to determine the minimum amortisation of net actuarial gains and losses in 2005, is 1,741 (the greater of 1,492 (10 per cent of the fair value of the actual plan assets at the beginning of 2005 of 14,920) and 1,741 (10 per cent of the actual obligation at the beginning of 2005 of 17,410)). Based on the above calculation, there is a net actuarial loss at 1 January 2005 of 1,820 (2,210 - 390). So the net actuarial loss exceeds the corridor and a portion is required to be recognised during 2005.

IAS 19.93 The net cumulative unrecognised actuarial gain or loss at the beginning of the period in excess of the corridor is amortised on a straight-line basis over the expected remaining working lives of the employees in the plan. However, an entity is permitted to account for actuarial gains and losses in any systematic method that results in faster recognition. Therefore, there is a choice to, for example:

- recognise all actuarial gains and losses immediately regardless of the corridor;
- recognise a stated percentage of the actuarial gains and losses immediately regardless of the corridor;
- amortise all actuarial gains and losses over the expected remaining working lives of the employees in the plan, or a shorter period; or
- not recognise any actuarial gains and losses that are within the corridor.

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IAS 19.93 Whichever method is chosen must be applied consistently to *all* defined benefit plans and from period to period.

In practice most entities recognise the minimum amount of actuarial gains or losses (i.e., spread actuarial gains and losses outside the corridor over the anticipated remaining working lives of the related employees).

Continuing the above example, the net actuarial loss in excess of the corridor at 1 January 2005 is 79 (1,820 - 1,741). If W wishes to recognise only the minimum amount, this excess is spread over the average remaining working lives of employees. If this is 10 years, the actuarial loss to recognise in 2005 is 7.9 (79/10).

This area of IFRSs may be subject to future developments (se 4.4.22).

Faster recognition

IAS 19 is silent regarding whether it would be acceptable to recognise immediately actuarial gains and losses *at the balance sheet date*, rather than those at the beginning of the period. In our view, faster recognition could include recognition of the actuarial gains or losses at the balance sheet date, as long as this policy is applied consistently. To ensure that the policy is applied consistently, we believe that it would be necessary to update the actuarial computations at each annual reporting date.

Retired employees

IAS 19.93 In our view, the average remaining working life generally should be determined considering *active* employees in the plan only. When a plan includes retirees whose benefit entitlement still is increasing, these retirees also should be considered.

However, in a situation when substantially all the participants in a plan are retired, we believe that both active and retired employees should be considered and an average remaining service life of zero should be attributed to retired employees. Therefore, in a plan with only retired participants, all the actuarial gains or losses outside the corridor should be recognised in the following year (if the corridor approach is applied) or in the current year (if an approach of immediate recognition is applied) as the average remaining working life is zero.

The average working life sometimes is calculated considering the remaining working life of all participants in the plan (i.e., including both active and retired employees (who have a remaining working life of zero)). However, this is less frequent in practice.

Anticipated future events

IAS 19.83 The benefits under a plan may depend on the outcome of future events (e.g., future salary levels or fulfilment of service conditions). These anticipated future events are considered to measure the employee benefit obligation if the entity has a legal or constructive obligation to pay the benefits. A change in expectations gives rise to actuarial gains or losses. For example, G has a defined benefit plan that is open to all employees in the finance department once they reach a certain salary level. The measurement of the obligation will take into account all employees expected to reach the specified salary level. If more employees than anticipated reach the specified salary level, an actuarial loss will arise.

IAS 19.86 Other future changes that the employer currently has a constructive obligation to make (e.g., inflation increases) also are included in the measurement of the obligation. However, future changes to the terms of a plan, so long as the employer does not have a constructive obligation to make these changes, are not anticipated in the measurement of the obligation. Therefore, continuing from the above example, if the terms of G's plan are changed to cover all employees, the change is treated as a plan amendment that may give rise to a past service cost (see below), or as a new plan.

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Review of actuarial gains and losses

IAS 19.92 The corridor and the amount of actuarial gains and losses to recognise are reviewed at least on an annual basis. Therefore, the amortisation year-on-year is unlikely to be consistent and, depending on the policy selected, if the cumulative unrecognised gains and losses fall within the corridor, amortisation may stop and restart again if it falls outside the corridor in a subsequent period.

Past service cost

IAS 19.7 Past service cost is the increase in the present value of the obligation, in respect of prior periods' service, due to changes in benefit entitlement. Examples of plan amendments that may give rise to past service cost include:

- changing the retirement age from 65 to 60;
- increasing the benefits that are payable on early retirement;
- changing the final salary on which the pension is based to include bonuses; and
- expanding the employee groups covered by the plans, with retrospective effect.

IAS 19.96 If such entitlements are not conditional on future service and, therefore, vest immediately the expense and an increase in the obligation are recognised in full immediately. To the extent that the benefits are not vested, the expense is amortised on a straight-line basis over the period until they vest.

For example, E increases the pension for all its employees from two per cent of final salary for each year of service to two and a half per cent for those employees who provide at least five years of service. The present value of the additional benefits for services rendered in the past is 150 for employees with more than five years of service and 120 for employees with less than five (on average two years of service). E recognises the vested benefits of 150 immediately. The 120 that is not vested is recognised on a straight-line basis over the average vesting period of three years (5 - 2).

Timing of recognition

IAS 19.52 In our view, a change in the obligation in respect of a past service cost should be recognised when an entity has a legal or constructive obligation to make the plan amendment. For example, on 1 November 2004, X decides to increase pensions of all employees by seven per cent with effect from 1 July 2005. X communicates the decision to the employees at 31 December 2004 and therefore should recognise the past service cost at that date, since it has no realistic alternative but to pay the increased benefits as a result of past practices.

Negative past service cost

Past service cost normally results in an increase in the liability (i.e., benefits are improved), but if benefits are reduced (e.g., if an entity retroactively changes its pension plan from a final pay system to an average pay system), those changes result in a reduction of the liability (negative past service cost).

It is important to determine whether a reduction of benefits gives rise to a negative past service cost or a curtailment. Changes that result in a material reduction in the *number of employees* covered by a plan, or that mean a material element of *future service* by the current employees no longer earns benefits or earns only reduced benefits, are treated as curtailments (see 4.4.13).

IAS 19.96 Past service costs that reduce the obligation are accounted for in the same way as a past service cost that increases it. Therefore, if the benefits are vested, a reduction in the liability and income is recognised immediately; if the benefits are not yet vested, the gain resulting from the reduction in benefits is spread over the vesting period.

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Balance sheet

IAS 19.54 The effect on the balance sheet of all of the above is that a liability is recorded as the present value of the obligation less the market value of the plan assets less unrecognised past service cost and less (plus) unrecognised actuarial losses (gains).

Example

The example below illustrates the accounting for a defined benefit plan.

The following information pertains to K's pension plan:

Plan assets at 1 January 2004	100,000
Defined benefit obligation at 1 January 2004	100,000
Unrecognised net actuarial loss at 1 January 2004	20,000
Average remaining working life of employees at 1 January 2004	10 years
Service cost for 2004	9,000
Discount rate at 1 January 2004	10%
Expected return on plan assets at 1 January 2004	10,000
Contributions by K to the plan in 2004	8,000
Benefits paid by the plan in 2004 to retirees	7,000
Net actuarial loss arising in 2004	2,000

K chooses to recognise the minimum amount of actuarial gains and losses.

The following accounting entries should be made in respect of the pension plan for the year ending 31 December 2004:

	Debit	*Credit*
Pension expense	9,000	
Pension liability		9,000
Recognise current service cost		
Pension expense	10,000	
Pension liability		10,000
Recognise interest cost (100,000 x 10 per cent)		
Pension liability	10,000	
Pension expense		10,000
Recognise expected return on plan assets		
Pension expense	1,000	
Pension liability		1,000
Recognise portion of actuarial loss that exceeds corridor ((20,000 - 10,000)/10)		
Pension liability	8,000	
Cash		8,000
Recognise contributions for the year		

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The pension cost recognised for the year is 10,000 made up as follows:

Current service cost	9,000
Interest cost	10,000
Expected return on plan assets	(10,000)
Actuarial loss recognised	1,000
Net cost for the year	10,000

The amount recognised in the balance sheet at 31 December 2004 is a net asset of 18,000. This represents the opening balance sheet position, plus the expense for the year, less contributions, as follows:

Obligation at 1 January 2004	100,000
Plan assets at 1 January 2004	(100,000)
Unrecognised actuarial loss	(20,000)
Balance sheet net asset at 1 January 2004	(20,000)
Net cost for the year	10,000
Contributions paid	(8,000)
Balance sheet net asset at 31 December 2004	(18,000)

Neither the benefits paid to employees directly by the plan nor the actuarial gains and losses arising in the current year affect the net cost for the year, or the roll forward of the opening to closing balance sheet positions.

The net unrecognised actuarial loss at 31 December 2004 is 21,000 (20,000 + 2,000 - 1,000).

Foreign currency denominated obligation

A defined benefit obligation may be denominated in a foreign currency, for example, a parent may have an obligation to employees of a foreign branch that is denominated in the local currency of the country in which the branch is located. An issue arises as to whether the obligation should be translated to the parent's functional (measurement) currency before or after applying the corridor and measuring the obligation. In our view, the net obligation first should be calculated in the currency in which it is denominated and the resulting obligation should be translated into the reporting entity's functional (measurement) currency. As a result, foreign exchange gains and losses are recognised immediately rather than entering into the determination of actuarial gains or losses.

4.4.8 Asset ceiling

IAS 19.58 If the balance sheet amount turns out to be an asset, then the amount recognised is limited to the present value of available contribution reductions or refunds plus unrecognised actuarial losses and unrecognised past service costs; further requirements ensure that a gain (loss) is not recognised solely as a result of an actuarial loss (gain) or a past service cost in the current period.

For example, E's defined benefit plan has the following characteristics:

Present value of obligation	11,000
Fair value of plan assets	(12,400)
Unrecognised actuarial losses	(1,100)
Unrecognised past service cost	(700)
Computed net asset	(3,200)

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The present value of anticipated reductions in future contributions as a result of the plan surplus is 1,000. The limit on the asset to recognise is calculated as follows:

Unrecognised actuarial losses	1,100
Unrecognised past service cost	700
Present value of anticipated reductions in future contributions	1,000
Limit on asset to recognise	2,800

Therefore, E will have an unrecognised surplus of 400 (3,200 - 2,800).

Benefits available

Issues often arise in practice about whether a surplus is available to the entity. The key issue is whether the entity *controls* the benefits.

Determining whether an entity controls the benefits will require a detailed analysis of the facts in each case, including the rules of the scheme and applicable legislation. However, as a general guide, in our view:

- If the plan terms indicate that the employer requires agreement from the trustees or employees to access the benefits, and such agreement has not been obtained, the entity does not control the asset. If the trustees or employees have agreed that the employer can recover the benefits through reduced contributions or some other means, then the entity controls the asset, if there are no regulations that prohibit such a recovery.
- If the plan terms indicate that the employer can obtain the benefits of the surplus without agreement from the trustees or employees, then the benefits are available to the employer, if there are no regulations that prohibit the recovery.
- If the plan terms provide for the surplus to be distributed to the employer as a refund, or to be considered in determining in future contributions, then the benefits are available to the employer.
- If the plan terms indicate that the employees are entitled to any surplus that exists (e.g., when they retire) then the benefits are not available to the employer.

Benefits distributed on unwinding of the fund

In some cases a surplus may be realised by the employer only on termination of the fund.

In our view, such benefits should be considered available only if the decision to terminate the plan rests with the employer and the employer realistically could terminate the plan and gain access to the benefits.

If it is probable that the employer will be able to terminate the plan and gain access to the benefit, the asset ceiling should be based on the amount of the surplus that will be available to the entity. If the employer will be entitled to a contribution holiday as well as any remaining surplus on termination of the fund, both of these aspects should be considered.

In our view, in determining the amount of the asset to recognise in respect of the surplus on termination of the fund, assumptions should be made on a termination basis rather than on a going concern basis.

Intended use of surplus

In our view, if an entity does not intend to use a surplus that is available to it, this may represent a constructive obligation to make a plan amendment that should be accounted for as a past service cost.

Sometimes an employer may decide to use an available surplus to improve the plan benefits. In our view, unless there is a legal or constructive obligation to improve the benefits, the surplus should be considered as being available to the employer in determining the amount of the asset to recognise.

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When there is a legal or constructive obligation to enhance the benefits, any resultant increase in the obligation should be treated as a past service cost (see 4.4.7).

Sharing of benefits

If any surplus is required to be shared between the employer and employees, or when past practice has established a valid expectation that the benefit will be shared, the portion that will be made available to the employees decreases the amount that could be recognised as a net asset by the employer.

Basis of measuring estimated future benefits

There is no guidance in IFRSs as to the assumptions that should be used in estimating the amount of future refunds or reduction in contributions. In our view, the measurement should reflect the best estimate of the amount to be received, determined on a basis consistent with the measurement of the plan assets and obligation, for example, discounted if appropriate.

Taxes on the surplus

If an entity will be required to pay income tax on the realisation of a surplus, it may be required to recognise a related deferred tax liability (see 3.12).

If a refund will be subject to a tax other than income tax, in our view the available surplus should be determined net of tax.

Multi-employer plans

The above principles also apply in determining whether a surplus is available to an employer that participates in a multi-employer plan to which defined benefit accounting is applied.

Prohibition on recognising a gain or loss as a result of actuarial losses and past service cost

IAS 19.58A The normal deferral of actuarial gains or losses due to the corridor is overridden in order to ensure that an entity does not recognise a gain (loss) solely as a result of an actuarial loss (gain) when the asset ceiling affects the measurement of a net pension asset. Therefore, an entity recognises immediately the following gains and losses, to the extent that these gains or losses arise while the ceiling test affects the measurement of the net pension obligation:

- net actuarial losses and past service costs to the extent that they exceed any reduction in the present value of economic benefits available in the form of refunds from the plan, or reductions in future contributions to the plan; or
- net actuarial gains less past service costs to the extent that they exceed any increase in the present value of economic benefits available in the form of refunds from the plan, or reductions in future contributions to the plan.

For example, C's pension fund had a net surplus of 700,000 at 31 December 2003. There were no unrecognised actuarial gains or losses. Under the terms of the plan, any surplus in the fund will benefit the employees. Therefore, applying the asset-ceiling test, C does not recognise a net asset in its balance sheet at 31 December 2003.

During 2004, the return on plan assets is lower than expected and an actuarial loss of 90,000 occurs. As a result the surplus at 31 December 2004 has decreased to 610,000. Normally, C would not recognise the actuarial loss (assuming it is within the corridor). As a result of the asset ceiling, C should now recognise an asset of 90,000 (the amount of unrecognised actuarial losses). This would result in income of 90,000 being recognised as a result only of the actuarial losses. Therefore, C also accelerates recognition of 90,000 of actuarial losses. As a result, it recognises no net gain and no net asset, and it has no unrecognised actuarial gains or losses.

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4.4.9 Current funding level deficit

There are no special requirements that apply when a plan has a deficit based on the current level of funding.

4.4.10 Insured benefits

General principles

IAS 19.39 When employee benefits are insured, the accounting treatment depends on the nature of the obligation retained by the employer.

IAS 19.39, 113 If an employer purchases an insurance policy from an unrelated third party and in so doing settles its legal and constructive obligations under a defined benefit plan, the purchase of the insurance policy is treated as a settlement of some or all of the employer's obligations (see 4.4.13). The cost of the policy is recognised as an expense (in effect defined contribution accounting). For guidance on purchases of insurance policies based on current salary and other policies that do not cover the entire obligation see guidance on *current salary policies and other limited cover*, below.

If the employer retains an indirect obligation (e.g., if actuarial risk will be transferred back to the employer by way of increased premiums, or the employer retains an obligation to pay the benefits through a plan), the plan must continue to be treated as a defined benefit plan. The insurance policy is treated as a plan asset, or as a separate asset, depending on the circumstances as explained below.

IAS 19.42 If the *employees* are the beneficiaries under a third party insurance contract, and the employer does not retain any legal or constructive obligation, the employer treats the purchase of insurance as a settlement (see 4.4.13).

For additional guidance on determining whether an employer has a legal or constructive obligation (see 4.4.3).

Insurance contract issued by a related party

IAS 19.7, 41 In our view, if the insurance entity is a related party of the employer, the employer retains an obligation and must continue to recognise the defined benefit obligation. The insurance policy is treated as a reimbursement right as explained below.

Insurance policies that qualify as plan assets

IAS 19.7 When a defined benefit obligation continues to be recognised in respect of insured benefits, the insurance policy is treated as a plan asset if:

- it is not issued by a related party of the entity; and
- the proceeds of the policy:
  - can be used only to fund defined benefit obligations;
  - are not available to the employer's creditors (even in the case of bankruptcy); and
  - cannot be returned to the entity except as reimbursement for employee benefits paid or when the proceeds are surplus to requirements.

In our view, if the insurance entity is a related party (see 5.5), an insurance policy held by the plan sponsor is not a plan asset even if the other conditions are met, and even if the related party establishes a separate fund related to the insurance policy.

Measurement

Insurance policies that are plan assets

IAS 19.54(d) A qualifying insurance policy is measured at fair value and included with other plan assets that are deducted from the related defined benefit liability.

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IAS 19.104 When the timing and amount of payments under a qualifying insurance policy exactly match the benefits payable under a plan, the present value of the related obligation is deemed to be the fair value of the insurance policy.

Insurance policies that are not plan assets

IAS 19.104C A right to reimbursement that arises from an insurance policy that is not a plan asset is recognised as a separate asset, rather than as a deduction in determining the net defined benefit liability. However, in all other respects, the insurance policy is treated in the same way as plan assets. In particular, net cumulative actuarial gains (losses) on the reimbursement right are considered in measuring the defined benefit obligation (see 4.4.7 for additional guidance).

Current salary policies and other limited cover

An employer may buy policies each period to settle all of its defined benefit obligations. In this case recognising as an expense the cost of the policies purchased (in effect, defined contribution accounting) will have the same effect as applying defined benefit accounting and recognising a settlement gain or loss. Although the accounting may be similar to defined contribution accounting, the disclosure requirements for defined benefit plans still may be relevant.

However, an insurance policy may not cover the employer's entire obligation. For example, P pays premiums under an insurance policy based on current rather than projected salary levels. The insurer, O, guarantees all the benefits earned to date but based on current salary levels. Defined benefit obligations are based on projected rather than current salary levels (see 4.4.5). Therefore, there is a difference between P's defined benefit obligation and the obligations assumed by the insurer under the insurance policy.

IAS 19.39 An insured benefit cannot be treated as a defined contribution plan if the employer has an obligation to make payments if the insurer does not pay *all* future employee benefits relating to employee service in the current and prior periods. Therefore, in our view, the entire plan should be accounted for as a defined benefit plan, and, to the extent that the liability is settled by the purchase of an insurance policy (based on current salary levels), this is treated as a partial settlement (see 4.4.13).

4.4.11 Reimbursement

IAS 19.104A When an entity will be reimbursed for expenditures required to settle a defined benefit obligation, but the reimbursement right does not give rise to a plan asset (see 4.4.6), it is recognised as a separate asset when recovery is virtually certain. An insurance policy that is not a plan asset gives rise to a reimbursement right (see 4.4.10).

IFRS 4.1G2 In our view, the reimbursement right must be due from a party outside the group. Therefore, assets held by another group entity to fund employee benefit obligations are not treated as reimbursement rights in the consolidated financial statements.

IAS 19.104A Reimbursement rights are accounted for in the same way as plan assets (i.e., they are measured at fair value). Actuarial gains and losses arising on reimbursement rights are included with the actuarial gains and losses arising on the related obligation, and are taken into account in determining the corridor (see 4.4.7). However, reimbursement rights are presented as a separate asset and are not netted against the related defined benefit obligation.

For example, O operates a defined benefit pension scheme for all its employees. O outsources certain of its employees to P, a third party. The outsourced employees continue to participate in O's pension plan but O is entitled to recover the costs of the outsourced employees, including costs associated with the defined benefit plan, from P. O should account for the full obligation under the defined benefit plan as explained above. If it is virtually certain that P will reimburse O for the pension costs, O should recognise an asset for the reimbursement, which should be accounted for in

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the same way as a plan asset. However, O should show the reimbursement right as a separate asset, and not deduct it from the carrying amount of the pension obligation.

Refunds of contributions

When an entity receives a refund of contributions paid to a defined benefit plan, the refund should be recognised as a reduction in the net pension asset (or an increase in the net pension liability). Receipt of the cash does not trigger recognition of income, as the measurement of the net obligation (or asset) would have included a "receivable" for the expected refund.

However, if there was a surplus in the fund that previously was not regarded as recoverable, and therefore not recognised, the refund gives rise to a gain. IFRSs are silent as to how the gain should be recognised, but in our view it should be treated as an actuarial gain and (depending on the policy chosen with respect to the corridor) its recognition should be deferred.

4.4.12 Inter-related post-employment benefit plans

An entity may have more than one post-employment benefit plan. In our view:

- If the post-employment benefits are financed through *a single scheme*, funded by one asset pool and (therefore) sharing the same investment risk, they should be considered and reported as a single plan. However, the terms of each component of the plan should be disclosed separately.
- If the benefits are funded through *different funds* or administered by one fund but have different arrangements, subject to *different investment risk*, they should be considered as separate plans. They may be combined in preparing disclosures for the financial statements if all are in a net surplus or a net liability position. Otherwise, offsetting is appropriate only if there is a legal right of offset between underfunding in one plan against overfunding of another plan.

For example, H is required by law to make severance payments to employees when they retire or leave. Severance payments reduce pension entitlement. If the anticipated severance payments are such that no pension payments will be required, then the defined benefit asset or obligation should reflect only the severance payments. If pension payments will be required in addition to the severance payments, then the pension liability should reflect the amounts that will be payable as a top-up to the severance payment. In any case, the calculation of the severance liability and the pension liability should reflect consistent actuarial assumptions (such as estimated future salary increases), but may have different inputs (e.g., benefits may be based on the final salary for the pension scheme, but on the average salary for the severance liability).

4.4.13 Settlements and curtailments

IAS 19.109 Settlements and curtailments trigger immediate recognition of the consequent change in the present value of the obligation and in the market value of the assets together with any previously unrecognised actuarial gains and losses or past service costs that relate to obligations impacted by the settlement or curtailment.

Scope of settlements and curtailments

IAS 19.112 A *settlement* is an early settlement of all or part of the plan obligation.

IAS 19.111 A *curtailment* occurs when the entity is demonstrably committed to reduce materially the number of employees in the plan or the benefits for *future* services. A change in future benefits is treated as a curtailment (rather than an actuarial gain or loss) if the effect of the remeasurement is material.

In some cases a settlement and a curtailment may occur together (e.g., as part of a restructuring some benefits may be eliminated, generally via payment (a settlement), and some future benefits may be reduced (a curtailment)). A settlement also may occur without a curtailment (e.g., when an employer purchases an insurance contract under which the employee is the beneficiary (see 4.4.10)). Similarly, a curtailment may occur without a settlement.

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Changes to a plan that are not settlements or curtailments give rise to past service costs (see 4.4.7), even if they occur as a result of a restructuring or a business combination.

Timing of recognition

The measurement of the obligation does not take into account planned curtailments or settlements, no matter how likely they are, until the entity is committed to the curtailment or settlement, with no realistic possibility of withdrawal.

In our view, the effects of a curtailment that relates to a restructuring generally would be recognised at the same time as the related restructuring (see 3.11). This is because the recognition criteria for a restructuring provision require there to be a detailed plan for the restructuring and the main features of the plan to have been announced to those affected by it (i.e., the employees). Once these criteria are met, the entity will be committed to the restructuring (and therefore to the related curtailment or settlement) with no realistic possibility of withdrawal, and the related curtailment or settlement gain or loss also should be recognised.

Calculation of gain or loss

IAS 19.110 An entity must update the actuarial computations of plan assets and obligations before computing the settlement or curtailment gain or loss.

IAS 19.109(c) Unrecognised actuarial gains and losses and unrecognised past service costs related to the curtailed portion of the liability must be allocated in determining the gain or loss. In our view, the actuarial gains and losses and past service costs used in the calculation should be those at the date of the curtailment, rather than at the end of the previous period.

IAS 19.115 There are no detailed requirements as to how actuarial gains and losses and past service costs should be allocated in determining the gain or loss; an example is given in the standard of a proportional allocation based on the change in the obligation.

4.4.14 Change in estimate

In general, a change in estimate is recognised in measuring profit or loss for the current and future periods (see 2.8). In our view, changes in the amount of a defined benefit obligation as a result of changes in the method of measuring the obligation (e.g., as a result of using a different measurement method under the projected unit credit method) are actuarial gains or losses.

Therefore, the adjustment resulting from a change in estimate in respect of a defined benefit plan will become part of the actuarial gains and losses and is subject to the corridor in the same way as other actuarial gains and losses. This means that the speed at which the amount is recognised in the income statement will depend on the size of the corridor and the entity's accounting policy for recognition of actuarial gains and losses (see 4.4.7).

4.4.15 Errors#

An incorrect classification of an employee benefit plan (e.g., as a defined contribution plan instead of a defined benefit plan) is an error.

Calculation errors also may arise if the assumptions used in the calculation are incorrect; for example, if certain eligible employees were not included in the calculation of the obligation.

The correction of an error that is not a fundamental error is accounted for in the current period; comparatives are not adjusted (see 2.8). In the case of a fundamental error, both opening retained earnings and comparatives should be restated.

The amounts that should have been recognised in previous periods are determined. In our view, any resulting adjustment should be recognised in the current year income statement (if the error is

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not fundamental) or as an adjustment to previous periods (for a fundamental error); not treated as an actuarial gain or loss. However, where appropriate, the calculation of the amount of the correction would reflect application of the corridor policy.

Forthcoming requirements

IAS 8 In December 2003, the IASB issued a revised version of IAS 8 *Accounting Policies, Change in Accounting Estimates and Errors*. The revised standard eliminates the distinction between fundamental and other errors and requires all errors to be dealt with in the same way as a prior period adjustment (see 2.8).

4.4.16 Change in classification

A plan may be reclassified from a defined benefit plan to a defined contribution plan or *vice versa*. For example, if information becomes available to account for a multi-employer plan as a defined benefit plan, then the accounting treatment should be changed accordingly.

There is no specific guidance on how to treat any gain or loss that might arise in this situation. In our view, when the accounting for a plan changes from defined benefit to defined contribution accounting, the change in classification should be treated as a settlement of the defined benefit plan (see 4.4.13). Therefore, any unrecognised actuarial gains and losses or past service costs should be recognised in the income statement immediately. When the accounting for a plan changes from defined contribution to defined benefit accounting, it should be treated as a new defined benefit plan.

4.4.17 Business combinations

IAS 19.108 Because an acquirer must measure assets acquired and liabilities assumed in a business combination at fair value, an acquired entity's pension arrangements are measured at the present value of the obligation less the fair value of plan assets at the date of acquisition (see 2.6). The present value of the obligation and the fair value of the assets are measured in accordance with IAS 19. The acquirer does not carry-forward unrecognised actuarial gains or losses or past service costs of the acquiree at the date of acquisition.

If this results in a net asset, the amount of the asset recognised is restricted to the amount recoverable as refunds or as reductions of future contributions.

For guidance on how to account for a modification of employee benefits triggered by a business combination see 2.6.

4.4.18 Other long-term employee benefits

Scope of long-term employee benefits

IAS 19.7, 128 An employee benefit payable *during* employment, other than equity compensation (see 4.5), but more than one year after the end of the period in which the employee services were rendered, is a long-term employee benefit. Such benefits include paid long-service leave, other long-service benefits (e.g., a bonus or extra salary after 20 years of service) and profit-sharing and other bonus schemes payable more than one year after the employee services were received by the entity.

IAS 19.7 Long-term benefits are accounted for as such in their entirety; the benefits are not split between the short- and long-term portions.

In our view, benefits that are payable on the earlier of termination of employment or on a specified date more than a year after the services are provided should be treated as other long-term benefits and not as post-employment benefits. For example, Y makes lump-sum payments to expatriate employees of one month's salary for each year of service. The amounts are paid every five years, or at the date of termination of employment if the employee leaves within the five year period.

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Given that the benefits are payable during employment, we believe that they should be treated as long-term benefits and not as post-employment benefits.

Accounting treatment

IAS 19.128 Other long-term employee benefits are accounted for in a manner similar to post-employment benefits, except that all actuarial gains and losses and past service costs are recognised immediately. The corridor approach may not be applied for other long-term benefits. Thus the employer's balance sheet includes a liability for the present value of the obligation less the market value of any plan assets.

The following example illustrates the accounting for long-term employee benefits.

On 1 January 2004, P introduced a benefit of an extra month's salary after a further five years of service for those employees working for P at 1 January 2004. The current monthly salary of the employees eligible for the benefits is 480,000 and 60 per cent of the employees are expected to work for five years and receive the benefit. The expected annual salary increase over the next five years is three per cent. The interest rate on high quality corporate bonds is 10 per cent.

The balance sheet obligation at 31 December 2004 for the eligible employees is calculated as follows:

Projected salary level after five years (future value of current salary with a three per cent increase:

PV = 480,000, i = 3 per cent, n = 4)	540,244
Present value of projected salary level at 31 December 2004 (present value of 540,244: FV = 540,244, i = 10 per cent, n = 4)	368,994
Adjusted benefit to take into account probability of employee working for the required five additional years (368,994 x 60 per cent)	221,396
Benefit attributable to current year (221,396/5 years)	44,279
Fair value of plan assets at 31 December 2004	-
Amount to be recognised as a liability at 31 December 2004	44,279

i = interest rate; n = numbers of years of service

Therefore, an employee cost and a corresponding liability of 44,279 are recognised at 31 December 2004.

In 2005, the calculation will be the same as above. Assuming that the interest rate and the anticipated level of employees expected to work for the five years is constant, this will result in a liability of 97,413 (present value of anticipated payment, i.e., 368,994 x 1.1 x 60 per cent x 2/5). The income statement will reflect an interest cost of 4,428 (44,279 x 10 per cent) and a service cost of 48,706 (97,413 - 44,279 - 4,428).

Long-term benefits that are not service related

IAS 19.130 When the amount of a long-term benefit is not dependent on the length of service, the benefit is recognised only when the event that gives rise to an obligation to make the payment occurs. For example, a liability for long-term disability benefits is recognised only when an event occurs that causes long-term disability, if the level of benefit is not dependent on years of service.

Defined contribution long-term benefit plans

IAS 19.126-131 Although IAS 19 implies that all long-term employee benefit plans are defined benefit plans, it does not specifically preclude defined contribution accounting for other long-term benefits. In some situations, in practice, other long-term employee benefit plans have the nature of defined contribution plans. In our view, defined contribution accounting should be used for these plans.

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4.4.19 Termination benefits

Generally, post-employment benefits are accrued over the service period. However, an obligation for termination benefits is regarded as arising from the termination and not from the employees' service; therefore, the obligation for termination benefits is not recognised until the entity is committed without realistic possibility of withdrawal to the termination. As such it is important to distinguish termination benefits from other post-employment benefits.

Scope of termination benefits

IAS 19.7 Termination benefits are those benefits that are payable as a result of an entity terminating employment before the normal retirement date, or an employee's decision to accept an offer of voluntary redundancy.

IAS 19.132 For example, N has a restructuring and, for a limited period of time, offers an early retirement package to all employees aged 55 to 57. Employees younger than 57 who accept the offer must continue to work until they reach age 57. In our view, the amount of the enhancement in retirement benefits for those employees accepting voluntary early retirement normally should be treated as termination benefits and not post-employment benefits. Notwithstanding the fact that there is a continuing service requirement, the event that gives rise to the payment is the offer of early retirement, not the employees' services. Salary and normal retirement benefits related to service between the ages of 55 and 57 are not treated as termination benefits. Instead these costs are recognised as the related services are performed.

As another example, assume that J, a restaurant, employs waiters and waitresses on short-term contracts and pays them a lump sum at the end of the contract period. In our view, the lump sum payments should be treated as post-employment benefits, rather than termination benefits, because the employees are entitled to the payments whenever they leave. The obligation does not accrue as a result of the decision to terminate employment. Therefore, the expense in respect of the lump sum payment is recognised over the service period.

If there is a service obligation as a condition of the payment, the payment may be a stay bonus rather than compensation for termination.

Recognition

IAS 19.133-138 Expenses and liabilities for termination benefits are recognised immediately when the employer has an obligation to make the payment. The cost is not spread over any remaining service period.

IAS 37.72 Two tests must be met for a termination provision to be recognised: there must be a formal plan in sufficient detail; and the entity must be demonstrably committed to the plan without realistic possibility of withdrawal.

For example, H is involved in contract cleaning. One of its major contracts is up for renewal next year and H does not expect the customer to renew the contract. In our view, the estimated costs of terminating the employees dedicated to the contract should not be recognised on the basis of probable non-renewal. There is no obligating event (i.e., the contract may be renewed or H may find replacement business and not need to make redundancies).

In our view, the specific employees who will be made redundant do not have to be informed that they are being made redundant (i.e., communicating a restructuring or termination plan to an employee group that includes the affected employees is sufficient to raise a valid expectation).

See 3.11 for guidance on the recognition of other costs associated with a restructuring. The timing of recognition of a provision for redundancies may differ from the timing of recognition of the other costs associated with a restructuring. For example, Q has met the criteria for recognising a restructuring provision, but has not yet communicated to the affected employees that the restructuring will involve

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redundancies. Q therefore, has an obligation for the restructuring costs before it has an obligation for the related employee termination costs.

Voluntary redundancies

The provision for voluntary redundancies should be measured at the best estimate of the anticipated outflow considering expected acceptances of the offer.

The general recognition requirements for termination benefits above also apply to voluntary redundancies. However, a provision is recognised only if it is probable that the offer will be accepted and the number of acceptances can be estimated reasonably.

For example, W's managing director can resign and receive a large payout if certain events, including a buy-out, occur. W has been acquired and the managing director has indicated that she intends to resign. This is a termination benefit similar to a voluntary redundancy. The triggering event has occurred and it is probable that the managing director will take the benefit. Therefore, in our view, a liability for the severance benefit should be recognised.

Measurement

Costs related to future services from employees who keep working after the redundancy has been announced, for example during a notice period, should not be recognised as a termination obligation.

Also, costs that are associated with ongoing activities are not recognised as a termination obligation. For example, M operates a chain of restaurants and decides to turn them into franchises. The restaurant managers, currently employees, will receive a redundancy payment if they agree to become franchisees. If they do not accept the offer they will remain as employees. Even if the plan has been communicated to the employees, no provision should be recognised. The employees are being paid to become franchisees, therefore the cost is associated with the ongoing activities.

4.4.20 Consolidation of employee benefit plans and employee benefit trusts

Post-employment benefit plans are classified as defined benefit or defined contribution plans (see 4.4.3); defined benefit plans are accounted for as set out in 4.4.7 (i.e., the resulting obligation is presented on a net basis in the balance sheet. The plans are not subject to normal consolidation principles).

An employer also may set up a separate entity to provide other employee benefits. Often the entity holds assets that are transferred to it by the employer. The assets then are used by the entity to settle its obligations to employees. For example, an employee benefit trust may hold shares in respect of options issued to employees (see 4.5), or cash that will be used to pay bonuses. The employer often has control over the entity.

There is no guidance in IFRSs on how to account for such plans. In our view, the employer should assess if the entity is an employee benefit plan. An employer does not consolidate an employee benefit plan, even if the plan holds assets that do not qualify as plan assets. The employer should account for its obligation under the employee benefit plan to provide the benefits in the same way as employee benefits that are settled directly by the employer – see 4.4.7 (i.e., the employer should recognise an obligation for the compensation that employees are entitled to receive based on services performed at each reporting date).

In our view, assets held by the fund that meet the definition of plan assets (see 4.4.6) should be measured at fair value and netted against the related liability. Assets that do not meet the definition of plan assets (e.g., because of transferability restrictions) should be accounted for as financial investments (see 3.6) or as treasury shares (see 3.10) and shown separately in the employer's balance sheet.

This area of IFRSs may be subject to future developments (see 4.4.22).

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4.4.21 Presentation and disclosure

Balance sheet presentation

Current / non-current classification

IAS 19.118 A distinction between current and non-current assets and liabilities arising from post-employment benefits is not required.

In practice assets and liabilities relating to *defined benefit plans* generally are classified as non-current, but if the distinction between the current and non-current portions is clear, split classification is permitted.

Assets and liabilities relating to *defined contribution plans* normally are current and are classified as such.

Offset

IAS 19.54 Assets that meet the definition of plan assets and the related liabilities must be presented on a net basis in the balance sheet. All other assets and obligations must be presented on a gross basis.

IAS 19.116 Net liabilities and net assets arising on different plans are presented separately, except in the rare circumstances when there is a legal right of offset and an intention to settle the plans on a net basis.

Income statement presentation

IAS 19.120(f), BC4(j) The components of the income statement charge for defined benefit obligations do not have to be charged or credited in the same income statement line item. The interest cost and expected return on plan assets may be included with interest and other financial income respectively, or the net total may be shown as staff costs. However, disclosure is required of the line items in which the components of the post-employment cost are recognised. In addition, whichever approach is adopted should be applied consistently.

In our view, actuarial gains and losses should not be split between those relating to investments and those relating to the obligation, even if interest and the expected return on plan assets are presented separately. Instead, recognition of actuarial gains and losses should be classified in the same item as current service costs.

Curtailments or settlements

IAS 19.120(e) In our view, when a curtailment or settlement arises as a result of the disposal of an operation, including a subsidiary, the resulting gain or loss may be shown as an adjustment to the gain or loss on disposal of the operation, or as a component of staff costs. Whichever presentation is adopted, the amount and nature of the curtailment or settlement gain or loss should be disclosed separately.

4.4.22 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Amendments to IAS 19

In April 2004, the IASB issued an exposure draft of proposed amendments to IAS 19. The exposure draft proposes:

- Including an option to recognise all actuarial gains and losses immediately in a statement of total recognised gains and losses (i.e., outside the income statement). The amounts would not be recycled through the income statement. Entities choosing to apply the option would have to apply it consistently to all defined benefit plans.
- To allow entities that participate in a group defined benefit plan to treat the plan as a defined contribution plan and / or multi-employer plan in their separate financial statements.

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- To require additional disclosures, including:
  - the major classes of plan assets and the expected rate of return for each class;
  - five-year histories of:
    - the present value of defined benefit obligations,
    - the fair value of plan assets,
    - the surplus or deficit in the plan and the experience gains or losses on plan assets, and
    - liabilities expressed as an amount and as a percentage of plan liabilities;
  - a reconciliation of plan assets and plan liabilities;
  - a description of the basis used to determine the return on plan assets; and
  - information about constructive obligations.

IFRIC

In May 2004, IFRIC published draft interpretation D6 *Multi-employer Plans*. This draft interpretation addresses when it is appropriate to apply defined contribution accounting for multi-employer plans. The draft interpretation emphasises that, before concluding a multi-employer plan is accounted for as a defined contribution plan, an entity must make every effort to determine the obligation. The draft interpretation also proposes guidance on the approach that should be adopted in applying defined benefit accounting for such a plan – measure the plan as a whole and then determine the relevant portion.

In June 2004, IFRIC published draft interpretation D7, a proposed amendment of the scope of SIC–12 *Consolidation – Special Purpose Entities*. As a result of this amendment, plans relating to share-based payments within the scope of IFRS 2 *Share-based Payment*, would be subject to the requirements of SIC–12. The scope exclusion for SIC–12 would be conformed to those employee benefit plans for which IAS 19 requires offset accounting (i.e., post retirement and other long-term benefit plans).

In July 2004, IFRIC published draft interpretation D9 *Employee Benefits Plans with a Promised Return on Contributions or Notional Contributions*. This draft interpretation addresses classification of plans with a minimum return guarantee and calculation of a defined benefit obligation when benefit entitlements are based on notional contributions.

IFRIC also is discussing issues relating to accounting for employee benefit trusts and similar entities in the separate (unconsolidated) financial statements of an entity.

Other

The IASB also is considering adding a comprehensive project to consider whether fundamental changes should be made to accounting for employee benefits; for example, elimination of the corridor method.

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4.5 Share-based payments

(IAS 19)

Overview

- **IFRSs do not contain any recognition or measurement requirements for share-based payments#.**
- **Extensive disclosures are required.**

Forthcoming requirements

In February 2004, the IASB issued IFRS 2 *Share-based Payment*. This new standard is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. It includes recognition and measurement requirements for many transactions and arrangements for which there currently is no guidance. Significant changes are likely to result from its adoption, in particular:

- the required recognition and measurement of share-based payments including those that are cash settled to both employees and non-employees; and
- modified disclosure requirements.

The requirements of IFRS 2 are discussed in section 4.5A.

The remainder of this section discusses the requirements of IAS 19, which are effective until an entity adopts IFRS 2.

4.5.1 Scope

IAS 19.7, 144 (2002)

Equity compensation benefits are those entitling an employee to the entity's (or its parent's) equity instruments or benefit otherwise dependent upon the price of such instruments (e.g., share appreciation rights).

Equity compensation plans include formal or informal arrangements under which an entity provides equity compensation benefits for employees. The related shares or options may be given to employees directly or indirectly (e.g., through a trust). Disclosures are required in respect of both types of arrangement.

4.5.2 Employee equity compensation schemes

IAS 19.145 (2002), 27.28

IFRSs have no recognition or measurement requirements for equity compensation benefits. IFRSs do, however, require consistent application of uniform accounting policies for like transactions; therefore whatever policy an entity adopts must be applied consistently.

In the absence of accounting guidance (i.e., until IFRS 2 becomes applicable), in our view it is acceptable to use a fair value, intrinsic value or historic cost model to account for equity compensation plans under IFRSs. In practice, many entities adopt an intrinsic value approach. Many also do not recognise any expense in profit or loss in respect of equity compensation plans.

As noted above, IFRSs require consistent application of accounting policies for *similar* transactions. In our view, different accounting policies can be selected for transactions with employees and for share-based payments to non-employees because of the different nature of these transactions.

Net cash cost

In our view, it is preferable that, at a minimum, any net cash outflow (i.e., any difference between the purchase price and the exercise price) incurred in relation to purchasing shares for employee compensation schemes be recognised as an expense. However, in the absence of specific guidance, an expense is not required to be recognised.

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Timing of expense recognition

In our view, it is preferable to recognise any expense over the period between the grant date and the vesting date, applying the principles in IAS 19 for accounting for long-term employee benefits. Other possible approaches include recognising an expense only on the vesting date, immediate recognition of an expense at grant date, or over the period of related performance conditions.

Example

T grants options to employees to purchase 900 shares at an exercise price of 10 in three years' time. At the date the options are granted, T buys 900 of its own shares for 12,000. At the option exercise date, T will transfer the shares to the employees and they will pay 9,000 (900 x 10). The net cash cost of the scheme to T is 3,000 (12,000 - 9,000). In our view, it is preferable to recognise this net cash outflow as an expense.

If the expense were spread over the vesting period the accounting entries would be as follows:

When the treasury shares are purchased:

	Debit	*Credit*
Equity	12,000	
Cash		12,000

Each year during the three year vesting period:

	Debit	*Credit*
Staff costs (3,000/3)	1,000	
Equity		1,000

When the options are exercised:

	Debit	*Credit*
Cash	9,000	
Equity		9,000

Measurement of expense

When an accounting policy is adopted that results in recognition of an expense for transactions under an equity compensation plan, measurement of the expense may require certain estimates (e.g., of forfeitures) especially when the (expected) expense is recognised over the vesting period. In our view, the measurement of the expense in respect of equity compensation schemes should reflect the best estimate of the anticipated outflow (the extent to which the employee will become entitled to an award under the scheme). Therefore, we recommend adjusting the expense recognised for anticipated forfeitures with a true-up based on the actual outcome.

Minimum value guarantee

If an entity provides a minimum value guarantee to employees in respect of options so that the entity will pay cash if the value of the options at the exercise date is less than a specified amount, in our view, it is preferable that a liability and a corresponding expense should be recognised, applying similar principles to those explained above. The measurement of the liability should reflect the expected cash outflow.

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Measurement date

In practice, entities that apply a fair value approach determine the value of the shares or options issued at various dates including:

- grant date (the dates at which the entity and another party (generally, an employee) agree to a share-based payment arrangement);
- service date (the date when the employee performs the services necessary to become unconditionally entitled to the shares or options);
- vesting date (the date at which the employee, having satisfied all the conditions necessary, becomes unconditionally entitled to exercise the options or otherwise acquire the shares); and
- exercise date (the date at which the shares are acquired or the options are exercised).

In our view, any of these dates may be used as the date for measuring the value of a share-based payment to employees, although our preference is for grant date measurement.

Loans related to equity compensation plans

An entity may obtain a loan to finance costs associated with an employee share scheme, or may make a loan to employees to enable them to purchase shares. Such loans should be accounted for in the same way as other loans, see 3.6 and 5.5. Hence, any transaction costs associated directly with the loans should be included in their initial measurement and amortised using the effective interest rate method.

Charges related to equity compensation plans

In some jurisdictions entities are required to pay social charges (e.g., taxes or levies) in respect of gains made by employees under equity compensation plans. In our view, these taxes or social charges are not share-based payments to employees but are short-term (or other long-term) employee benefits and should be expensed accordingly. Often these taxes or social charges are not due until a later date (e.g., exercise date) and the recognition and measurement principles for employee benefits (either short-term or long-term, depending upon the due date) must be applied (see 4.4). Therefore, a liability should be estimated and recognised.

In our view, it is preferable for such costs to be accrued between the grant and vesting dates, consistent with the general approach of recognising employee costs evenly over the service period (or recognised in another manner consistent with the entity's accounting policy, see above). In the absence of specific guidance, other possible approaches include initial recognition at grant date or only on the vesting date.

The measurement of the obligation should reflect the best estimate of the anticipated charges. The charges often are based on the difference between the option strike price and the share price at the exercise date. In our view, the share price at the balance sheet date normally should be used to measure the obligation. Another measurement basis may be used if this provides better evidence of the estimated amount of the outflow. If the related share-based payment is measured at fair value, consistent assumptions should be made in valuing the share-based payment and in measuring the provision for social charges. Also, in our view, a consistent approach should be applied regarding adjustment for anticipated forfeitures (to which no social charges or taxes would apply).

Treasury shares held in respect of employee benefit plans

SIC 16.3 (1998)

It is not clear whether the requirements to present treasury shares and treasury share transactions in equity (see 3.10) apply to treasury shares held in connection with an equity compensation plan. Although the requirements regarding treasury shares do not establish recognition and measurement guidance for equity compensation plans, in our view the requirements should be applied to the presentation of treasury shares held in connection with those plans. However, in the absence of clear guidance, in practice such treasury shares sometimes are presented as an asset#.

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See 4.4 for further discussion of employee benefit trusts.

Forthcoming requirements
In December 2003, the IASB amended IAS 32 to clarify that the general requirements for treasury shares apply to treasury shares held in respect of equity compensation plans (see 3.10).

Shareholder contributions

In some cases shareholders contribute shares to satisfy the obligation to employees. In practice different methods are used to account for these contributions from shareholders. The most common practices are to recognise shareholders' contributions either as capital contributions (movements in equity) or as gains in the income statement. In our view, such transactions between shareholders and employees should be recognised by the entity. We prefer recognising the contribution of own shares as a capital contribution.

4.5.3 Share appreciation rights

Equity compensation plans to employees include those settled in cash such as share appreciation rights, when a payment is made based on changes in the share price over a specified period. IFRSs do not specify recognition or measurement principles for cash-settled equity compensation plans. In our view, it is preferable for a liability and an expense to be recognised in respect of transactions under cash-settled equity compensation plans. We believe that it is preferable to measure the provision at the best estimate of the amount payable calculated based on the share price at each balance sheet date. This will result in an expense being recognised based on the amount paid to the employees.

For example, M grants 1,000 share appreciation rights to employees when the share price is 100. The employees will receive a cash payment equal to the increase in the share price above 100 when the share appreciation right is exercised. To cover its exposure arising from the scheme, M purchases 1,000 of its own shares at the date it grants the share appreciation rights. Three years later, when the share price is 150, the employees exercise their rights. Therefore, M is required to pay the employees 50,000 (1,000 x (150 - 100)). M also sells the treasury shares on that date. The following are the accounting entries that will be recorded if our preferred approach is followed:

When the rights are granted and the treasury shares purchased:

	Debit	*Credit*
Equity (treasury shares)	100,000	
Cash		100,000
To reward the purchase of the treasury shares		

When the rights are exercised and the treasury shares are reissued:

	Debit	*Credit*
Employee costs	50,000	
Cash		50,000
To record the cash cost as an expense		
Cash	150,000	
Equity (treasury shares)		100,000
Equity (retained earnings)		50,000
To record the sale of treasury shares		

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4.5.4 Share-based payments to parties other than employees

IAS 18.12

Until IFRS 2 becomes applicable there is no IFRS that deals specifically with the accounting for share-based payments to parties other than employees. In our view, it is appropriate to draw an analogy with the principles that apply for non-cash transactions, which require non-cash transactions to be recognised at fair value.

Therefore, we believe that an expense or asset should be recorded based on the fair value of the goods or services received and appropriate disclosures should be provided.

If the fair value of the goods or services received cannot be measured reliably we would expect the transaction to be measured at the fair value of the equity instruments granted.

If the fair value of the equity instruments also cannot be determined reliably then the transaction may be measured based on the nominal value of the shares issued, when appropriate, with extensive disclosure of the terms of the transaction and parties involved.

4.5.5 Disclosure

Extensive disclosures are required.

IAS 19.7, 147, 148

The definition of equity compensation benefits includes equity instruments issued to employees by an entity or its parent. Therefore, in our view, all the required disclosures should be given also in respect of equity compensation benefits given to employees by the entity's parent. In addition, in our view, a parent that provides equity compensation benefits to the employees of its subsidiaries should provide disclosures in its financial statements in respect of such benefits.

In our view, it is helpful to include disclosure of a notional expense in respect of equity compensation schemes, for example, based on fair value. However, if such disclosure is made, the basis used to measure the notional expense should be explained.

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4.5A Share-based payments
(IFRS 2)

Overview

- **The standard is effective from 1 January 2005, with early application encouraged.**
- **Goods or services received in a share-based payment transaction should be measured at fair value.**
- **Goods should be recognised when they are obtained and services recognised over the period that they are received.**
- **Share-based payments to non-employees generally are measured based on the fair value of the goods or services received.**
- **Equity-settled grants to employees generally are measured based on the fair value of the instruments (e.g., options) issued at the grant date.**
- **Equity-settled grants are not remeasured for subsequent changes in value.**
- **Estimates of the number of equity-settled instruments that vest are adjusted to the actual number that vest unless forfeitures are due to market-based conditions.**
- **Cash-settled transactions are remeasured at each balance sheet date and at the settlement date.**
- **For equity-settled transactions an entity recognises a corresponding increase in equity.**
- **For cash-settled transactions an entity recognises the liability incurred.**

In February 2004, the IASB issued IFRS 2 *Share-based Payment*. The standard is effective for annual accounting periods beginning on or after 1 January 2005. The transitional requirements are described below (see 4.5A.9).

4.5A.1 Scope

IFRS 2.A In a share-based payment transaction an entity receives goods or services and pays for those goods or services either in shares or in other equity instruments. A transaction also is considered to be a share-based payment if the entity incurs a liability whose amount is based on the price of an equity instrument of the entity.

Transactions settled in shares or other equity instruments are referred to as equity-settled share-based payment transactions. Transactions that create an obligation to deliver cash or other assets are referred to as cash-settled share-based payment transactions.

IFRS 2.3 Share-based payment transactions within a group of entities (e.g., a subsidiary issuing options over its parent's shares) and share-based payments made directly by shareholders on behalf of a reporting entity are within the scope of the standard. For example, if a parent grants options to the employees of a subsidiary, this is accounted for in the subsidiary's separate financial statements as a share-based payment.

IFRS 2.5, 6 However, the following share-based payment transactions are covered by other IFRSs:

- share-based consideration for the net assets acquired in a business combination (see 2.6); and

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- share-based consideration for certain commodity contracts that are within the scope of IAS 32 and IAS 39 (see 3.6).

4.5A.2 Basic recognition principles

IFRS 2.7 The following basic recognition principles apply for all share-based payment transactions:

- goods and services received or acquired in a share-based payment transaction are recognised when the goods are obtained or as the services are received;
- goods and services acquired in a share-based payment transaction are recognised as an expense unless they qualify for recognition as an asset under another standard;
- a corresponding increase is recognised in equity if the goods or services are acquired in an equity-settled share-based payment transaction; and
- a liability is recognised if the goods or services are acquired in a cash-settled share-based payment transaction.

4.5A.3 Classification and definitions

IFRS 2.2 More detailed requirements for recognition and measurement are provided for each of the following categories of share-based payment transactions:

- equity-settled share-based payment transactions (including shares or share options);
- cash-settled share-based payment transactions (including share appreciation rights); and
- transactions when there is a choice of cash or equity settlement by either the reporting entity or the counterparty.

Equity versus liability

IFRS 2.31 All terms and conditions of the arrangement should be considered when determining whether a share-based payment transaction is equity-settled or cash-settled. A share-based payment transaction in which the employees are granted the right to shares that are redeemable (e.g., mandatory redeemable shares) is a cash-settled share-based payment arrangement.

4.5A.4 Equity-settled transactions with employees

Recognition

IFRS 2.14 If the employee is not required to satisfy a specified condition (either a service condition or a performance condition) before becoming unconditionally entitled to the instruments granted, then the equity instruments vest immediately. Therefore, there is a presumption that the services rendered as consideration for these instruments have been received and the fair value of these instruments is recognised immediately with a corresponding increase in equity.

IFRS 2.15 If the employees are not entitled unconditionally to the instruments at the date of grant, the entity presumes that services will be received in the future. The entity accounts for the services as they are received during the vesting period.

Determination of grant date

IFRS 2.11 Determination of grant date is important, since this is the date that the fair value of equity instruments granted is measured. Usually the grant date also is the date when recognition of the employee services received begins. However, this is not always the case (see below).

IFRS 2.A Grant date is the date at which the entity and the employee agree to a share-based payment arrangement, and requires that the entity and the employee have a shared understanding of the terms and conditions of the arrangement. If the agreement is subject to an approval process, grant date cannot be before that approval is obtained. When a grant is made subject to approval, for example, by a board of directors, grant date normally is when that approval is obtained.

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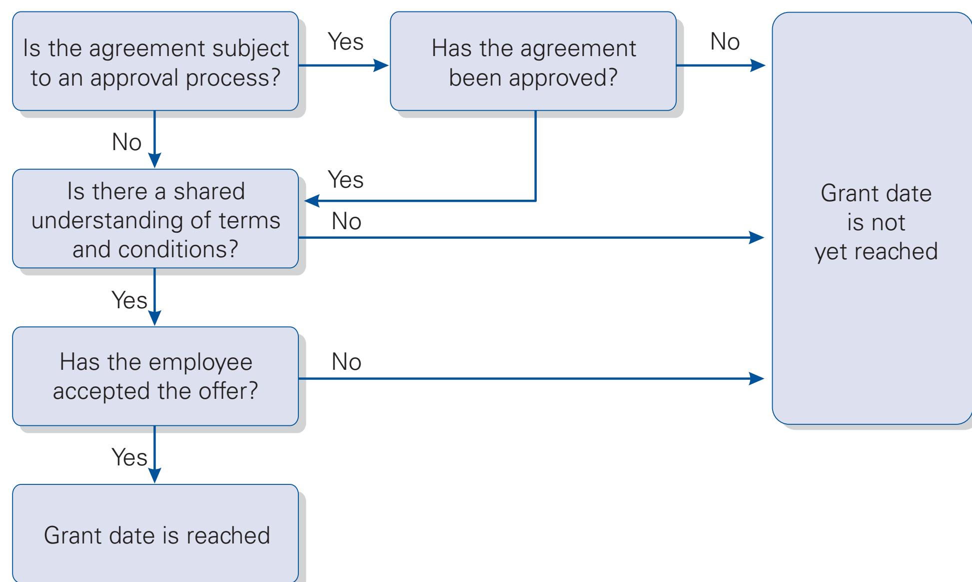
IFRS 2.16 2 In order for the employer and the employee to *agree* to a share-based payment transaction, there must be both an offer and an acceptance of that offer. The grant date is not reached until there is acceptance of the offer. The acceptance may be explicit (e.g., by signing a contract) or implicit (e.g., by commencing to render services).

A shared understanding may not require finalisation of all the terms and conditions. For example, an offer may not specify the *actual* exercise price, but instead will state the *formula* that determines how the actual exercise price will be established. In our view, when the outcome is based on *objective* factors and different knowledgeable parties, independently of each other, would be able to make consistent calculations, then there is a shared understanding without having specified the actual grant term. If, for example, the exercise price is based on the market price at a specified later date but the outcome of all other factors are known already, then there is a shared understanding at the date of the agreement of the way that the exercise price will be determined.

In our view, generally there will not be agreement on terms and conditions if the outcome is based on *subjective* factors (e.g., if the number of shares to be awarded is a discretionary determination of a compensation committee at the end of the service period). Similarly, if the number of instruments issued to employees is determined based on a (partly) *subjective* evaluation of the individual's performance over a period, in our view there is not a shared understanding until the number of instruments has been determined.

The determination of grant date can be illustrated as follows:



Determination of vesting period

IFRS 2.A The vesting period is the period in which all the specified vesting conditions are to be satisfied in order for the employees to be unconditionally entitled to the equity instrument. Normally this is the period between the grant date and the vesting date.

IFRS 2.IG4 However, services should be recognised when received and grant date therefore might occur after the employees have begun rendering services. Grant date is a measurement date only. When the grant date occurs *after* the service commencement date, the recognition of services during the period from service commencement date until grant date would be based on the estimated fair value at grant date. Once the grant date has been established, the entity should revise the earlier estimate so that the amounts recognised for services received are based on the grant date fair value of the equity instruments. In our view, this revision is treated as a change in estimates (see 2.8).

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Graded vesting

IFRS 2.IG11

In some situations the equity instruments granted vest in instalments over the specified vesting period (e.g., 100 options are granted and 25 options vest each year over the next four years). Assuming that the only vesting condition is service from the grant date to the vesting date of each tranche of 25 options, then each instalment should be accounted for as a separate share-based payment arrangement (i.e., four separate option grants with one, two, three and four-year vesting periods, respectively). As a result, even though all four grants are measured at the same grant date, the total expense recognised each year will be different as both the fair value and the vesting periods are different.

Determination of the type of equity instruments granted

IFRS 2.16, 17 example 11

All terms and conditions of the arrangement should be considered when determining the type of equity instruments granted (e.g., shares or options). For example, some Employees Share Purchase Plans (ESPPs) are not "true" ESPPs since the substance of the grant is an *option* and not a *share*.

Determining whether a plan is a "true" ESPP or an option plan will impact both the determination of what the grant date is and the measurement of the fair value of the grant. Consider, as an example, an entity that grants the right to purchase shares at a 20 per cent discount to its share price. This grant is made to 1,000 of its employees and 700 employees purchase shares. If the substance of the offer is an ESPP, grant date is the date when the employees accept the offer (by purchasing shares) and the recognition therefore would be based on the 700 employees accepting the offer. However, if the substance of the offer were an option grant, then recognition would be based on the "option" instruments granted to the 1,000 employees and not on the 700 employees that exercise their options.

In our view, the predominant feature of the share-based payment arrangement decides how the entire fair value of the grant should be accounted for.

Options are characterised by the *right*, but not the *obligation*, to purchase a share at a fixed price. An option has a value (i.e., the option premium) since the option holder has the benefit of any future gains and has none of the risks of loss (beyond any option premium paid). The value of an option is determined in part by its duration and by the expected volatility of the share price during the term of the option. In our view, the principal characteristic of an ESPP is the right to buy shares at a discount to current market prices. ESPPs that grant short-term fixed purchase prices, or longer-term fixed percentage discounts to current market prices, do not have significant option characteristics since they do not allow the grant holder to benefit from volatility. In contrast, we believe that ESPPs that provide a longer-term option to purchase shares at a fixed price are, in substance, option agreements, and should be accounted for as options.

If, for example, the employees are entitled to purchase shares at a fixed price from the date of communication of the plan until two years later, this effectively is an option and should be accounted for as an option plan and not as an ESPP. Whether the predominant feature in a specific agreement is the *option feature* requires judgement based on all the terms and conditions of the plan.

In some share-based payment arrangements, the employees are entitled to shares for no cash consideration, however the grant is conditioned upon fulfilment of certain specified vesting conditions. The value of such an equity instrument is not the value of the share at grant date. Instead the grant is in effect an option with an exercise price of zero. When the employees benefit from all potential gains and have only limited risks, this is effectively an *option feature*.

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Measurement

Determining the fair value of equity instruments granted

IFRS 2.11 Share-based payment transactions with employees must be measured by reference to the fair value of equity instruments granted.

IFRS 2.16, 17 The fair value of the equity instruments granted is determined as follows:

- If market prices are available for the equity instruments granted, the estimate of fair value should be based on these market prices.
- If no market prices are available for the equity instruments granted, the fair value of equity instruments granted is estimated using a *valuation technique*.

IFRS 2.24 In rare cases, when the fair value of the equity instruments cannot be estimated reliably, an intrinsic value method approach is applied, with the intrinsic value remeasured at each balance sheet date until the instrument is settled (e.g., until an option is exercised).

Modified grant date method

IFRS 2.19-21, 2.16 9 The modified grant date approach is used to recognise and measure equity-settled share-based payment transactions. Under this approach the fair value of the equity instruments is measured at grant date, with some 'true up' for instruments that do not vest (commonly known as 'forfeiture').

IFRS 2.19-21, 2A, 2.16 9 The modified grant date approach requires entities to distinguish between the following types of conditions:

- *service conditions*, which require employees to complete a specified period of service; and
- *performance conditions,* which can be either:
  - market conditions, when vesting or exercisability of an equity instrument is related to the market price of the entity's equity instruments (e.g., a specific share price or total shareholder return (measured based on share price, adjusted for reinvestment of dividends)); or
  - non-market conditions, when vesting or exercisability of an equity instrument is related to specific performance targets (e.g., a specified increase in profit).

IFRS 2.21 Market performance conditions are reflected only in the initial estimate of fair value at grant date and there is no true up for differences between estimated and actual vesting due to market conditions.

IFRS 2.20 The impact of service conditions and non-market performance conditions are estimated at grant date. Subsequently these estimates are trued up for differences between the number of instruments expected to vest and the actual number of instruments vested.

Equity-settled transactions are not remeasured for subsequent changes in the grant date estimate of fair value. They also are not trued up if vested options are not exercised.

4.5A.5 Cash-settled transactions to employees

IFRS 2.30 Cash-settled share-based payment transactions result in a liability (generally, an obligation to make a cash payment) based on the price of the equity instrument (e.g., share price). For cash-settled share-based payment transactions the services received and the liability incurred are measured at the fair value of the liability at grant date. The initial measurement of the liability is recognised over the period when services are rendered.

Each balance sheet date, and ultimately at settlement date, the fair value of the liability is remeasured with any changes in fair value recognised in profit or loss for the period. The total charge in respect of the transaction will be the amount paid to settle the liability.

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4.5A.6 Employee transactions with a choice of settlement

IFRS 2.34 When either the entity or the employee has a choice of settlement, the transaction should be accounted for as a cash-settled transaction if a liability to settle in cash or other assets has been incurred. To the extent that no such liability has been incurred, the transaction should be accounted for as an equity-settled transaction.

IFRS 2.35-38 When the employee has the choice of settlement, the entity has granted a compound financial instrument that includes a debt component and an equity component. At the measurement date, the fair value of the compound instrument (the value of services to be received) is the sum of the values of the debt component and the equity component. The debt component should be measured first. Generally, all of the fair value of the grant will be recognised as a liability since the employee would have to surrender the cash settlement right in order to receive the equity alternative. As a result the incremental value of the equity component often is zero.

IFRS 2.41-43 When the entity has the choice of settlement, it should determine whether it has a present obligation to settle in cash. If the entity has no stated intent and no past practice of settling in cash, then the entity accounts for the grant as an equity-settled transaction. Otherwise the entity must account for it as a cash-settled transaction.

4.5A.7 Modifications and cancellations of employee transactions

IFRS 2.27 Modifications to equity-settled share-based payment transactions that *decrease* the fair value of the grant are ignored. When the fair value of the grant *increases* due to a modification, then the incremental value of the modified grant as compared to the value of the original grant at the date of modification should be accounted for in addition to the original grant over the remaining (or revised) vesting period.

IFRS 2.28 Cancellations or settlements of equity instruments during the vesting period are accounted for as accelerated vesting and therefore any unrecognised cost is recognised immediately.

4.5A.8 Non-employee transactions

IFRS 2.11, A The requirements for transactions with employees also must be applied to transactions with individuals who may not be an employee, but provide personal services similar to services provided by an employee. This includes non-executive directors.

IFRS 2.13 For equity-settled share-based payment transactions with non-employees there is a rebuttable presumption that the fair value of the goods or services received can be measured reliably. If the presumption is rebutted then the entity must measure the fair value of the goods or services received by reference to the fair value of equity instruments granted (i.e., like an employee grant). However, unlike an employee grant, the fair value of goods or services received is measured when the goods are *obtained* or services are *rendered*. As a result, a single payment agreement may have multiple measurement dates (i.e., one for each date that goods or services are received) rather than being measured only once at the original grant date.

IFRS 2.30 For cash-settled share-based payment transactions the goods or services received are measured at the fair value of the liability. The liability is remeasured at each balance sheet date and at the date of settlement in the same way as with cash-settled transactions with employees.

4.5A.9 Transitional provisions

IFRS 2 applies for annual periods beginning on or after 1 January 2005. Entities are encouraged to early adopt the standard. IFRS 2 contains transitional provisions for existing IFRS users that adopt IFRS 2. The transitional provisions applicable to a first-time adopter of IFRSs are discussed in 6.1.

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Cash-settled transactions

For cash-settled share-based payment transactions outstanding at the beginning of the annual period in which IFRS 2 is adopted, the standard is applied retrospectively and comparatives are adjusted (see 2.8), except that an entity is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.

Entities are encouraged, but not required, to apply IFRS 2 retrospectively to other liabilities arising from share-based payment transactions (e.g., liabilities settled in 2004).

Equity-settled transactions

The transitional requirements in respect of equity-settled share-based payment transactions are summarised below.

IFRS 2 applies to equity-settled transactions granted:	Original grant	Modifications *before* the effective date	Modifications *after* the effective date
On or before 7 November 2002	Optional[1]	Optional[2]	Mandatory
After 7 November 2002, but vesting before the effective date	Optional[1]	Optional[2]	Not applicable
After 7 November 2002 and vesting after the effective date	Mandatory	Mandatory	Mandatory

Notes:
1 Entities are permitted to apply IFRS 2 only if the fair value of the equity instruments has been disclosed publicly.
2 In our view, entities are required to account for the modifications of the grant under IFRS 2, if the recognition and measurement principles of IFRS 2 were applied to the original grant.

4.5A.10 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In June 2004, IFRIC issued a draft interpretation, D7 *Scope of SIC–12 Consolidation – Special Purpose Entities*. D7 proposes to amend SIC–12 to remove the exemption for equity compensation plans (share-based payments). As a result, treasury share accounting must be applied in the consolidated accounts for shares held by a SPE that is required to be consolidated based on the criteria (and scope) of the amended SIC–12.

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4.6 Financial income and expense

(IAS 18, IAS 23, IAS 39)

Overview

- **Interest income and expense is calculated using the effective interest rate method#.**
- **Incremental transaction costs directly related to raising finance or acquiring a financial asset are included in the initial measurement of the instrument#.**
- **Interest generally is expensed as incurred. Interest related to qualifying assets may be capitalised if certain conditions are met.**
- **Interest on both general borrowings and on specific borrowings is eligible for capitalisation. The amount capitalised is net of investment income on the temporary investment of specific borrowings.**

Forthcoming requirements

In December 2003, a revised version of IAS 39 *Financial Instruments: Recognition and Measurement* was issued. Revised IAS 39 also introduced certain changes to IAS 18 *Revenue*. The revised standard is effective for accounting periods beginning on or after 1 January 2005. Early adoption is permitted. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular the revised standards:

- clarify and provide additional guidance on how the effective interest method should be applied; and
- provide additional guidance regarding the types of transaction costs allowed to be included in the initial measurement of the financial instruments.

4.6.1 Introduction

This section provides guidance on determining financial income and expense and capitalising borrowing costs, and addresses issues relating to the presentation of financial income and expense. See 3.6 for guidance on how to measure and when to recognise gains and losses on financial instruments and 2.7 for guidance on how to determine foreign exchange gains and losses.

4.6.2 Recognition and measurement

Interest income and expense

IAS 18.30, 39.9, 39.AG 5-8

Interest income and expense is calculated using the effective interest rate method. The *effective interest rate* is the rate that exactly discounts the expected stream of future cash payments or receipts through to maturity or the next market-based repricing date to the current net carrying amount of the financial asset or financial liability on initial recognition.

For example, Y grants a five-year loan of 50 million to Z on 1 January 2004. There is an annual coupon of 10 per cent paid on the last day of each year. Borrower pays a fee of one million and so the loan proceeds are 49 million. The effective interest rate is calculated by solving for *x* in the following equation:

$$49,000,000 = 5,000,000/(1 + x) + 5,000,000/(1 + x)^2 + 5,000,000/(1 + x)^3 + 5,000,000/(1 + x)^4 + 55,000,000/(1 + x)^5.$$

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The effective interest rate is, therefore, 10.53482 per cent. The amortisation schedule is as follows:

Date	*Interest (10.53482%)*	*Coupon*	*Amortisation of discount*	*Amortised cost*
1 January 2004	-	-	-	49,000,000
31 December 2004	5,162,063	5,000,000	162,063	49,162,063
31 December 2005	5,179,136	5,000,000	179,136	49,341,199
31 December 2006	5,198,008	5,000,000	198,008	49,539,207
31 December 2007	5,218,868	5,000,000	218,868	49,758,075
31 December 2008	5,241,925	5,000,000	241,925	50,000,000
Total	26,000,000	25,000,000	1,000,000	

To calculate the effective interest in each period, the effective interest rate is applied to the amortised cost of the loan at the end of the previous period. The difference between the calculated effective interest for a given period and the asset's coupon is the amortisation (or accretion) during that period of the difference between the proceeds of the loan and the amount due on maturity. The amortised cost of the loan at the end of the previous period plus effective interest accrued in the current period plus or minus any cash receipts or payments equals the amortised cost at the end of the current period.

The effective interest rate method differs from the straight-line method in that the amortisation under the effective interest rate method reflects a constant return on the carrying amount of the asset or liability.

The effective interest rate is calculated on initial recognition of an instrument. For practical reasons, the effective interest rate on a floating rate instrument generally is not reassessed each time market interest rates change when the impact would not be significant. Interest income or expense is recognised instead based on the current market rate plus or minus amortisation or accretion of discount or premium based on the original effective interest rate.

Interest, dividends, losses and gains must be reported in a way that is consistent with the classification of an instrument as a liability or equity (see 5.6). Therefore, dividends on shares classified as liabilities must be reported in the income statement as finance costs, as must any gains or losses arising on their early redemption or refinancing. Gains or losses on instruments classified as equity are recognised directly in equity.

Effective interest rate calculation

Contractual or expected cash flows

IAS 18.30, 32.61 (1998), 39.9

The effective interest rate generally is calculated based on contractual cash flows. If expected cash flows differ from contractual cash flows (e.g., because of anticipated prepayments), the effective interest rate should be based on *expected* rather than *contractual* cash flows. However, in determining *expected* cash flows, no adjustment should be made for anticipated credit losses.

In our view, consideration should be given to any options and similar terms attaching to an instrument in determining its effective interest rate. For example, the effective interest rate on a convertible instrument should be calculated considering the expected conversion date of the instrument. When an instrument gives either the issuer or the holder the option to require the instrument to be redeemed or cancelled early, and the terms of the instrument are such that it is not certain whether the option will be exercised, the probability of the option being exercised should be assessed in determining the effective interest rate#.

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Forthcoming requirements

IAS 39.9, 39.AG5-8

The revised standard clarifies that estimated cash flows and all contractual terms of the financial instrument (e.g., prepayment, call and similar options) should be considered when calculating the effective interest rate. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. Future credit losses are not taken into account as this would be a departure from the incurred loss model for impairment recognition.

However, at the same time the revised standard notes that in some cases, for example, when a financial asset is acquired at a deep discount, credit losses have occurred and are reflected in the price. If an entity does not take into account such credit losses in the calculation of the effective interest rate, the entity would recognise a higher amount of interest income than that inherent in the price paid. Therefore, such credit losses should be included in the estimated cash flows when computing the effective interest rate.

The revised standard emphasises that future cash flows and the expected life can be estimated reliably for most financial instruments. However, it is acknowledged that in some rare cases it might not be possible to estimate the timing or amount of future cash flows reliably. Therefore, in such cases, the entity should use contractual cash flows over the full contractual term of the financial instrument.

Instruments measured at fair value

IAS 32.94(h)

Interest generally must be recognised in the income statement on interest-bearing instruments that are measured at fair value. Interest is calculated using the original effective interest rates of the instruments, not current market rates (to be consistent measurement of the instruments at amortised cost), even though current market rates are used to determine the fair value of interest-bearing instruments.

Q&A 170-2 (2000)

Interest income on instruments that are held for trading may be, but does not need to be, shown shown separately on the face of the income statement. Alternatively, the income statement may report a single amount for trading income, with interest income disclosed in the notes#.

Forthcoming requirements

IAS 39

Under the revised standard, the requirement to disclose interest income on financial instruments classified as held for trading has been withdrawn.

Changes in timing or amount of expected cash flows

There is no guidance in IFRSs on how to account for the impact of changes in the timing or amount of expected future cash flows, other than for those changes that relate to impairment.

In our view, the effective interest rate should be recalculated when there is a change in the estimated timing or amount of future cash flows. This is necessary to achieve appropriate recognition of any unamortised discount or premium, or transaction costs. The impact of any change should be shown as an adjustment to current and future interest in the same way as other changes in accounting estimates (see 2.8)#.

Forthcoming requirements

IAS 39.AG8, 39.BC36

The revised standard provides some guidance on the accounting for the impact of changes in the expected cash flows. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial instrument (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in the income statement.

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In our view, this new guidance on changes in expected cash flows should apply to changing prepayment expectations but not to contractual changes in cash flows such as a change in the applicable variable interest rate (see also paragraph below on restructuring of a financial liability).

Restructuring of a financial liability

IAS 39.41, 39.AG62

If the terms of a financial liability are modified substantially, resulting in an extinguishment of the old financial liability the old liability is derecognised and the restructured financial instrument is treated as a new financial liability (see 3.6 for guidance as to when the terms of a financial liability are considered to be modified substantially). In our view, any unamortised discount or premium or transaction costs related to the old financial liability, should be recognised in the income statement as an adjustment to the gain or loss on derecognition of the old financial liability. If a modification of a financial liability does not result in derecognition of the financial liability the effective interest rate of the financial liability should be recalculated based on the revised terms of the financial liability at the date of the modification. Any transaction costs and fees and commissions related to the modification should be recorded as an adjustment to the carrying amount of the financial liability and amortised over the remaining term of the modified financial liability.

Restructuring of a financial asset and recognition of interest income on impaired financial assets

If the terms of a loan, receivable or held-to-maturity investment (see 3.6) are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, an entity (creditor) should consider whether an impairment loss on the financial asset has been incurred. If the creditor concludes that an asset is impaired, the creditor should measure the loss as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate before the modification of terms (i.e., the effective interest rate computed at initial recognition).

Once a financial asset has been written down to its estimated recoverable amount, interest income is recognised based on the rate of interest that was used to discount future cash flows for the purpose of measuring the recoverable amount.

Instruments acquired in a business combination

Interest-bearing instruments that are acquired as part of a business combination accounted for as an acquisition are measured at their fair value at the date of the acquisition (see 2.6), even if they otherwise would be carried at amortised cost.

At the acquisition date, the fair value of the instrument and the total payments expected to be made over the remaining term of the instrument should be used to calculate a revised effective interest rate for the instrument. The revised effective interest rate should be used to determine the interest income or expense in the consolidated financial statements.

Hedged item in a fair value hedge

IAS 39.89(b)

An interest-bearing instrument that is the hedged item in a fair value hedge will be remeasured to fair value in respect of the risk being hedged during the period of the hedge relationship (see 3.6) even if the item normally is carried at amortised cost.

IAS 39.92

When hedge accounting is discontinued, the carrying amount of the instrument and the total payments to be made over the remaining term of the instrument should be used to calculate a revised effective interest rate for the instrument. The revised effective interest rate should be used to determine interest income in subsequent periods.

Discounts and premiums and pre-acquisition interest

IAS 39.AG6

Generally, discounts and premiums are recognised over the expected period to maturity of the related instrument using the effective interest rate at the date of initial recognition of the instrument.

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However, in some cases a shorter period should be used if this is the period to which discounts and premiums relate.

IAS 39.AG6 If a discount or premium arises on the acquisition of a floating rate instrument, it is important to identify the reason for the discount or premium. A discount or premium on a floating rate instrument could relate to *interest accrued* on the purchase date.

Alternatively, the discount or premium could arise because the *market yield* of the instrument differs from its coupon rate, in which case the discount or premium is amortised over the period to the expected maturity of the instrument. This may happen if the credit risk on the instrument has changed since the instrument was issued.

For example, when an interest-bearing instrument is acquired between interest payment dates, normally the buyer has an obligation to pay the accrued interest to the seller when it is received, or pays a higher price for the instrument to reimburse the seller for the accrued interest that will be paid to the buyer.

IAS 18.32 Interest that accrues before an interest-bearing investment is acquired is not recognised as income. If there is an obligation to pay the accrued interest to the seller, a receivable and a corresponding payable are recognised in respect of the accrued interest. If an additional amount is paid to the seller at the time the instrument is acquired in compensation for the accrued interest, then the accrued interest purchased is excluded from the cost of the investment and recognised as interest receivable#.

Forthcoming requirements

IAS 39.AG6, 39.BC34 The revised standard provides additional guidance on when any fees, points paid or received, transaction costs and other discounts or premiums should be amortised over a period shorter than the expected life of the instrument. This will be the case when the variable to which fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next repricing date.

For example, if a premium or discount on a floating rate instrument reflects changes in market rate since the floating interest rate was last reset to market, it will be amortised to the next repricing date.

Straight-line amortisation of discounts or premiums is not permitted.

The amortisation of discounts or premiums is included in interest income or expense and is not required to be disclosed separately.

Stepped interest#

IAS 39.9, 39.IG.B27 When the contractual terms of an instrument include uneven interest payments, the effective interest rate method is used to allocate the interest over the term of the instrument to achieve a constant rate on the carrying amount.

For example, on 1 January 2004 B places a five-year deposit with the following rates of interest specified in the agreement: 6.0 per cent in 2004, 8.0 per cent in 2005, 10.0 per cent in 2006, 12.0 per cent in 2007 and 16.4 per cent in 2008. The effective interest rate for this instrument is approximately 10.0 per cent. Therefore, interest is accrued using the 10.0 per cent rate.

Forthcoming requirements

IAS 39.9, 39.BC30-32 The revised standard clarifies that estimated cash flows and all contractual terms of the financial instrument (e.g., prepayment, call and similar options) should be considered when calculating the effective interest rate.

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In the given example, if B expects the deposit to be withdrawn after four years, then this expectation should be taken into account when calculating the instrument's effective interest rate. As a result the effective interest rate would be approximately 8.8 per cent, which should be used to accrue interest income over the deposit's expected life.

Similar issues arise in respect of mortgage loans and credit cards that are issued with a low initial rate of interest in order to attract new customers. After a period, the interest rate typically returns to a standard market rate so that the lender is able to recover the discount over the remaining estimated life of the instrument. Normally any initial discount should be recognised as part of the effective yield over the estimated life of the instrument. However, in our view, any discount that is in excess of that offered to all market participants should be recognised immediately as an expense. Any penalties that are receivable on early settlement, and that compensate the lender for lost interest, also are factored into the lender's calculation of the effective yield.

Transaction costs#

IAS 39.43 Incremental transaction costs directly related to originating or acquiring a financial instrument are included in the initial measurement of the instrument. Transaction costs therefore are included in the measurement of interest income or expense.

For example, K issues debt of 100,000 at par and incurs direct incremental issue costs of 5,000. The debt will be redeemed at par. Ignoring interest, there is a difference of 5,000 between the net proceeds (95,000) and the redemption amount (100,000). This difference represents the transaction costs and is recognised as an expense using the effective interest rate method over the period the debt is outstanding.

Any transaction costs that do not qualify to be included in the initial measurement of an instrument must be expensed as incurred. These costs normally are included in the financial income or expense line item.

IAS 39.9, 39.AG13 Only transaction costs that are directly related to originating or acquiring a financial instrument and that would have been avoided if the instrument had not been originated or acquired (e.g., brokers commissions, credit assessment, registration charges and similar costs) are included in the initial measurement of the instrument.

Service fees are not directly attributable to the acquisition of an asset or liability. Similarly, costs of researching or negotiating an instrument or assessing alternatives must be expensed as incurred.

Forthcoming requirements

IAS 39.43, B9.16.E.1.1 The revised standard requires a financial asset or financial liability to be recognised initially at its fair value plus, in the case of a financial asset or financial liability not designated to be measured subsequently at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial instrument.

Transaction costs on financial instruments designated to be measured subsequently at fair value through profit or loss are charged immediately to the income statement.

Internal costs

In our view, incremental internal costs also should be included in the initial measurement of a financial instrument#.

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IAS 39.AG13

Forthcoming requirements

The definition of transaction costs in the revised standard clarifies that only costs that are incremental to the individual instrument should be included in the initial measurement of a financial instrument. In our view, the only internal transaction costs allowed to be included in the initial measurement of a financial instrument are commissions, bonuses and other payments that are made to employees on the completion of each individual transaction. We believe that internal semi-variable costs, for example, the costs of marketing a new product or of employing additional staff to deal with an increase in the volume of transactions, do not qualify as transaction costs.

Transaction costs on floating rate instruments

There is no specific guidance as to how transaction costs on a floating rate loan should be amortised. In our view, an entity may select any reasonable methodology, as long as it is applied consistently to all floating rate instruments. The most common approach in practice is to calculate the amortisation schedule based on market interest rates at the inception of the instrument and not adjust this schedule for subsequent changes in market interest rates. It also would be acceptable to recalculate the amortisation as market interest rates change over the term of the loan.

Facility fees paid

IAS 18.A14(b)(ii)

An issue that often arises is how to treat facility fees (i.e., initial fees to cover negotiation and arrangement of a facility and periodic fees to compensate the financier for keeping funds available).

In our view, an initial facility fee typically is, in substance, an adjustment to the interest cost on the facility and therefore the fee should be treated as an adjustment to the instrument's effective interest rate and recognised as an expense over the estimated period of the facility. However, if it is not probable that a facility will be drawn-down, the fee is considered as a service fee and recognised as an expense on a straight-line basis over the commitment period.

The above accounting treatment would result in mirror accounting adopted by a borrower and a lender.

Termination fees paid

In our view, any penalties or fees that will be payable on settlement of an instrument should be expensed as incurred. These fees should not be considered in determining the effective interest rate of the instrument, even if early termination is expected, unless the fees are payable regardless of when or why the instrument is settled#.

IAS 39.9, 39.BC 30, 31

Forthcoming requirements

The revised standard requires computation of the effective interest rate based on estimated rather than contractual future cash flows.

In our view, an entity should distinguish between termination fees being in substance an adjustment to the instrument's effective interest rate and penalty fees. For example, if a loan termination fee is determined by reference to the loan's income (e.g., equal to the lender's lost income if a mortgage loan with a below-market interest rate over the first two years is early terminated), such a termination fee, in our view, should be included in the calculation of the instrument's effective interest rate. However, when termination fees are in excess of the amount required to compensate the lender for lost income (penalty fees), then the excess element should not be included in the calculation of the effective interest rate, but should be treated as a contingent liability. Therefore, an appropriate allocation of the termination fee between an adjustment to the instrument's effective interest rate and the penalty fee might be required.

The facts and circumstances of each type of termination fee should be considered in determining the appropriate accounting treatment.

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Reimbursable transaction costs

IAS 18.A14, 39.43

In some cases, an entity will charge fees to a third party as reimbursement for transaction costs incurred in acquiring a financial instrument. The transaction costs nevertheless should be included in the initial measurement of the instrument. The fee income should be treated in the way described below. The transaction costs may not be offset against the related fee income.

Fee income

IAS 39.AG64, 18.A14

The accounting treatment of fee income relating to interest-bearing instruments depends on whether the fees are an integral part of the effective yield of the instrument.

Fees that are an integral part of the effective yield of an instrument are recognised as an adjustment to the effective interest rate of the instrument. Examples include:

- origination or commitment fees;
- compensation for transaction costs incurred; and
- appraisal fees for evaluating collateral (e.g., for mortgage loans).

Normal revenue recognition principles apply to other fees, for example, those that are earned as services provided (e.g., fees charged for servicing a loan) or those that are earned on the execution of a significant act (e.g., commission on the allotment of shares to a client). See 4.2 for general guidance on revenue recognition.

Dividend income

IAS 18.30

Dividend income should be recognised when the shareholder's right to receive payment is established.

In our view, the shareholder's right to receive payment of dividends on *quoted* investments normally is established on the date the security trades ex-dividend. At this date the fair value of the security decreases by approximately the dividend amount. Therefore, recognising a dividend on the ex-dividend date will avoid double counting (which would occur if the dividend was included both as income and in the measurement of the fair value of the investment). The ex-dividend date is the first date when a sale of the instrument would not settle before the record date. The record date is the date when shareholders have to be included in the register of shareholders in order to receive the dividend. Calculation of the ex-dividend date will depend upon local trading and settlement practices.

In our view, for dividends on *unquoted* investments, the shareholder's right to receive payment normally is established when the shareholders have approved the dividends. If shareholder approval is not required for a dividend distribution, a right to receive payment may be established when the dividends are declared. When determining the fair value of such investments, care should be taken to avoid double counting dividends as both receivables and part of the fair value estimate.

For example, P's directors declare a dividend on 10 March. The dividend is approved by shareholders on 25 March and will be paid to shareholders of record (i.e., in the shareholders' register) on 31 March. If P's shares are listed in a market that has a three day settlement, the shares would trade ex-dividend from 28 March (assuming all are business days). Therefore, we believe that dividend income should be recognised on 28 March. If P's shares are not listed, we believe that the dividends should be recognised when they are approved (i.e., 25 March). Thereafter, the dividends should be excluded when estimating the fair value of the shares.

IAS 18.32

Dividends that are paid out of pre-acquisition earnings should be recognised as an adjustment to the cost of the investment, not as income. In practice, determining the pre-acquisition portion of dividends may be difficult and dividends are recognised as income unless they clearly represent a recovery of the investment#.

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Forthcoming requirements

IAS 27.4

The revised IAS 27 *Consolidated and Separate Financial Statements* clarifies that the investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of the investment and must be recognised as a reduction of the cost of the investment.

Share dividends

In some cases, shareholders may receive or choose to receive dividends in the form of additional shares rather than cash. These may be referred to as scrip, stock or share dividends. In our view, the substance of stock dividends with a cash alternative is the payment of a cash dividend, with reinvestment of the cash in additional shares. Therefore, we believe that dividend income should be recognised for the amount of the cash dividend alternative. The corresponding debit should be treated as an additional investment.

IAS 39.43

In other cases an entity may receive bonus shares with no cash alternative. Share investments generally are classified as trading or available-for-sale investments and therefore always measured at fair value with gains and losses on remeasurement to fair value recognised either in the income statement or in equity (see 3.6).

If all shareholders receive bonus shares in proportion to their shareholdings, the fair value of each shareholder's interest should be unaffected by the bonus issue. In our view, no accounting entries should be made.

If only certain shareholders are granted additional shares, the fair value of the interests of those shareholders will increase. In this case, in our view, it is most appropriate to measure the shares received at their fair value and recognise a corresponding amount of financial income.

4.6.3 Imputed interest

IAS 39.43, 39.AG64

If, at the time of its initial recognition, a debt instrument or loan does not bear interest at a market rate, interest must be imputed. The instrument initially is measured at its fair value determined by discounting the expected future cash flows at a market interest rate (see 3.6 for guidance on how to treat the difference between the proceeds and the fair value of the instrument).

Interest is accrued on the instrument over the period to maturity, based on the imputed rate, using the effective interest rate method. Unless the instrument is modified (see 4.6.2), the effective interest rate is not revised based on subsequent changes in market interest rates as the purpose of imputing interest is to reflect market rates at the time of the acquisition transaction.

For example, L receives an interest-free loan of 900. The loan is repayable in five years. A market interest rate for a similar loan at the date the loan is granted is five per cent. The fair value of the loan at initial recognition is 705 (the cash flow of 900 in five years discounted at five per cent). The loan, therefore, initially is recognised at 705. The difference of 195 is recognised as financial income unless it meets the definition of a liability or equity. In each of the five years that the loan is outstanding, interest is accrued on the carrying amount of the loan at five per cent. Therefore, in the first year the interest expense is 35 (705 x 5 per cent). In the second year the interest expense is 37 ((705 + 35) x 5 per cent). At the end of five years, the carrying amount of the loan will be 900.

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4.6.4 Capitalisation of borrowing costs

IAS 23.10, 11 Borrowing costs may be capitalised as part of the cost of certain "qualifying assets", although an alternative treatment is to expense interest expense as incurred.

IAS 8.13 An entity that chooses to capitalise borrowing costs must capitalise all borrowing costs on all qualifying assets.

Qualifying assets

IAS 23.4 A qualifying asset is one which necessarily takes a substantial period of time to be made ready for its intended use or sale. Qualifying assets generally are those that are subject to major development or construction projects.

IAS 23.6 Investments (including, in our view, investments in associates and subsidiaries) are not qualifying assets. However, investment property may be a qualifying asset.

In our view, an asset that is ready to be used when it is purchased is not a qualifying asset, even if expenditure subsequently is incurred on the asset.

There is no specific guidance on how long a "substantial period of time" is, but in our view, it is a period well in excess of six months.

Inventories that are manufactured routinely in large quantities or that are produced on a repetitive basis in a short time are not qualifying assets, even if the production process is subject to delays (up to a few months), for example, while waiting for raw materials to arrive.

IAS 23.6 Only inventories that take a long time to produce (e.g., whisky or property) can be qualifying assets.

IAS 23.4 The term "necessarily" is included in the definition of a qualifying asset to indicate that the nature of the asset must be such that it takes a long time to get it ready for its intended use or sale. Therefore, in our view, an asset that takes a long time to prepare for use or sale only because of inefficiencies in the development process is not a qualifying asset.

Refurbishment

There is no guidance in IFRSs regarding whether an asset that is being refurbished can be a qualifying asset. In our view, an asset being refurbished can be a qualifying asset, if the refurbishment costs qualify for capitalisation (see 3.2) and if the refurbishment will take a substantial period of time and the other criteria are met. For example, G owns and manages a hotel and has a policy of capitalising borrowing costs. The hotel is closed down for a major refurbishment. The refurbishment costs will be capitalised and the refurbishment will take 18 months. We believe that the borrowing costs related to the refurbishment should be capitalised since this is the policy adopted by the entity.

Borrowing costs eligible for capitalisation

IAS 23.5 In addition to interest, borrowing costs eligible for capitalisation include:

- amortisation of discounts or premiums and transaction costs on the effective interest rate method# (see 4.6.2);
- finance charges in respect of finance leases (see 5.1); and
- exchange differences to the extent that they are regarded as an adjustment to interest costs (see below).

IAS 23.11, 13 The borrowing costs that may be capitalised are those that otherwise would have been avoided. This includes interest on borrowings made specifically for the purpose of obtaining the qualifying asset (specific borrowings) and costs of other borrowings that could have been repaid if expenditure on the asset had not been incurred (general borrowings).

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Forthcoming requirements

IFRIC 1.8 IFRIC 1 clarifies that interest expense recognised from unwinding of a discount on decommissioning or restoration provisions is an interest expense that may not be capitalised.

Interest rate swaps

IFRSs are silent on whether interest rate swaps that effectively alter borrowing costs should be considered in determining the amount of borrowing costs to capitalise.

In our view, accruals under interest rate swaps should be included in determining the amount of borrowing costs to capitalise, given the principle that finance costs should include those costs that could have been avoided if expenditures on the qualifying asset had not been made. However, in our view, it is not acceptable to consider the changes in fair value of interest rate swaps as a borrowing cost. The fair value of an interest rate swap is the present value of expected future cash flows and it does not represent borrowing costs incurred.

Tax

The amount of borrowing costs to capitalise is calculated on a pre-tax basis.

Foreign exchange differences

IAS 23.5 Borrowing costs may include foreign exchange differences to the extent that these differences are regarded as an adjustment to interest costs. There is no further guidance on the conditions under which foreign exchange differences may be capitalised and in practice there are different views about what is acceptable.

In our view, foreign exchange differences on borrowings can be regarded as an adjustment to interest costs only in very limited circumstances. Exchange differences may not be capitalised if a borrowing in a foreign currency is entered into or offset with another currency exposure because interest determined in a foreign currency already reflects the exposure to that currency. Therefore, the foreign exchange differences to be capitalised should be limited to the difference between interest accrued at the contractual rate and the interest that would apply to a borrowing with identical terms in the entity's functional (measurement) currency. Any foreign exchange differences arising from the notional amount of the loan should be recognised in profit or loss.

When exchange differences qualify for capitalisation, in our view both exchange gains and losses should be considered in determining the amount to capitalise.

If an entity changes the currency exposure of future interest payments in a foreign currency using a derivative, in our view the interest (time value) component of the fair value of the derivative could be included in eligible borrowing costs. However, in our view, it would not be appropriate to treat all changes in the fair value of the derivative as a borrowing cost.

Dividends

IAS 32.18(a), 20 In our view, distributions and similar payments on instruments classified as liabilities (e.g., dividends on preference shares that are classified as a liability (see 5.6)) are eligible for capitalisation.

Imputed interest on non-financial liabilities

In our view, imputed interest on non-financial liabilities (e.g., the unwinding of the discount effect on provisions) may not be capitalised#.

Forthcoming requirements

IFRIC 1.8 IFRIC 1 clarifies that interest expense recognised from unwinding of a discount on decommissioning or restoration provisions is an interest expense that may not be capitalised.

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Calculating the amount of borrowing costs to capitalise

Specific borrowings

IAS 23.15 The amount of specific borrowing costs capitalised is net of the investment income on any temporary investment of the funds pending expenditure on the asset.

In our view, if borrowing costs that were capitalised in a previous period subsequently are reimbursed, the amount capitalised should be reversed.

General borrowings

IAS 23.17 To the extent that the financing incurring interest costs to be capitalised is part of the entity's general borrowings, the weighted average interest cost (excluding the interest on any borrowings specific to any qualifying assets) is applied to the expenditures on the asset.

IAS 23.17 In our view, the weighted average expenditures during the period on the asset, reduced by any progress payments or grants received in respect of the asset, may be used in calculating the amount on which interest is capitalised. The amount capitalised may not exceed the actual interest incurred by the entity.

The objective is to capitalise borrowing costs that would have been avoided if expenditures on the asset had not been incurred. Therefore, in our view, different capitalisation rates may need to be used for different assets. For example, C, a bank, has a policy of capitalising borrowing costs. C is developing a property that is a qualifying asset. C has deposits from customers as well as various other sources of financing. The deposits from customers are used to finance loans and advances to customers, not capital projects. In our view, in calculating the amount to capitalise, C should consider the borrowing costs it incurs only on the borrowings it has to finance projects, not the borrowing costs on its interest-bearing deposits.

Calculation in the consolidated financial statements

IAS 23.14 There is specific guidance in IFRSs relating to the calculation in consolidated financial statements beyond the comment that in some cases the amount of borrowing costs to capitalise should be based on a weighted average borrowing rate applicable for a group rather than a weighted average rate applicable to an individual entity's borrowings.

In our view, the approach adopted for a group's consolidated financial statements should be one that reflects the borrowing costs attributable to a particular qualifying asset. Entity-specific rates are likely to be the most appropriate for an individual entity within a group that is financed independently. For an entity that is financed largely by internal borrowings, a group borrowing rate is more appropriate. Only external borrowings should be considered in calculating a weighted average group borrowing rate.

Calculation in separate financial statements

In our view, only borrowing costs incurred by the group entity that has incurred expenditure on a qualifying asset are eligible for capitalisation in the entity's separate financial statements. For example, H borrows funds on behalf of its subsidiary S. H makes an equity investment in S and S uses the capital to construct a qualifying asset. H cannot capitalise the borrowing costs incurred on the financing in its separate financial statements, as it does not have a qualifying asset. Similarly, S does not have eligible borrowing costs and cannot capitalise borrowing costs as part of the cost of the asset. However, in the consolidated financial statements, borrowing costs should be capitalised if the other criteria for capitalisation are met and H has an accounting policy of capitalising borrowing costs.

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Period of capitalisation

Commencement

IAS 23.20 Capitalisation begins when:

- expenditures for the asset are being incurred;
- borrowing costs are being incurred; and
- activities that are necessary to prepare the asset for its intended use or sale are in progress.

If funds are raised in advance to finance a major capital project, capitalisation of borrowing costs cannot begin until the project starts. Capitalisation is limited to interest costs incurred after expenditures are incurred.

IAS 23.22 Activities that are necessary to get an asset ready may include technical and administrative work before construction begins, such as obtaining permits. Therefore, in the case of property constructed on owned land, finance costs may be capitalised in respect of the land, once technical and administrative activities are in progress.

Suspension

IAS 23.23 Capitalisation of interest must be suspended during extended periods in which active development is interrupted. For example, capitalisation should be suspended if development of a qualifying asset is suspended because an entity is waiting for parts to arrive.

There is no guidance on what length of time is considered an extended delay.

IAS 23.24 Capitalisation may continue during a temporary delay that is caused by an external event, such as rain or flooding that is common in the region; or during an interruption caused by technical or legal obstacles that are a typical part of the process. Capitalisation also may continue during a period where *substantial* administrative or technical work is being carried out. In our view, if the administrative or technical work is not significant, then capitalisation should be suspended.

Cessation

IAS 23.25 Capitalisation should cease when the activities necessary to prepare the asset for its intended use or sale are substantially complete. For example:

- V has constructed a chemical plant. Construction is complete but minor modifications to the plant are required to meet the user's specifications before it is brought into use. We believe that capitalisation should stop when the construction is complete.
- W has developed a residential property to lease out. The development process is complete, but the property requires minor decoration before it is leased out. We believe that capitalisation should stop when the development process is complete.

4.6.5 Presentation and disclosure

IAS 1.81 A separate line item is required on the face of the income statement for finance costs. There is no requirement to present finance income on the face of the income statement unless such presentation is relevant to an understanding of the entity's financial performance. Significant categories of revenue including interest and dividends should be disclosed in the financial statements#.

There is no guidance in IFRSs as to what should be included in financial income and expense. In our view, when financial activities are incidental to an entity's principal activities, financial income and expense should include the following items:

- interest income and expense, including amortisation of discounts and premiums and transaction costs (see 4.6.2);
- dividend income;

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- foreign exchange gains and losses arising from investing and financing activities, such as exchange gains and losses on financial investments or exchange gains and losses on foreign currency borrowings (see 2.7);
- gains and losses on derivatives related to investing and financing activities, for example, gains and losses on interest rate swaps or gains and losses on foreign currency forward contracts that hedge foreign currency borrowings (see 3.6);
- gains and losses on disposal of financial investments;
- gains and losses on trading activities;
- impairment losses and reversals of impairment losses on financial investments; and
- unwinding of discounts on non-financial assets and liabilities (see below).

Interest income and expense includes interest that is recognised when an asset or liability initially is measured at a discounted amount, for example, the interest expense that arises on a provision that initially is measured at a discounted amount (see 3.11) or the interest that is imputed on the cost of an asset when payment for the asset is deferred beyond normal credit terms (see 3.7).

IAS 1.81(a) If one of an entity's principal sources of revenue is interest or dividend income, then interest or dividend income should be presented as revenue separately on the face of the income statement.

IAS 1.34, 35 In practice, finance costs often are presented on a net basis. In our view, this is acceptable as long as financial activities are incidental to an entity's principal activities, because IAS 1 allows gains and losses arising from a group of similar transactions (e.g., foreign exchange gains and losses and gains and losses arising on financial instruments held for trading) to be reported on a net basis#.

Forthcoming requirements

IAS 1.81 Revised IAS 1 issued in December 2003 requires presentation on the face of the income statement of a line item for finance costs.

IAS 21.52 There is no specific guidance regarding which line items in the income statement should include foreign exchange gains and losses, although the total amount of exchange differences must be disclosed. There also is no guidance on the presentation of gains and losses on derivatives. In practice some entities present foreign exchange gains and losses and gains and losses on derivatives relating to operating activities (e.g., those related to foreign currency sales and purchases) in operating income and the other exchange gains and losses in financial income or expense. Other entities present all exchange gains and losses in the financial income or expense line item. In our view, either of these approaches is acceptable as long as it is applied consistently and, when amounts are material, the policy is disclosed.

In our view, income and expenses related to shares that are classified as a liability, for example, dividends on redeemable preference shares, may be included with interest on other liabilities or presented separately.

IAS 32.67 The effective interest rates of interest-bearing financial instruments must be disclosed. The disclosure may be given for individual financial instruments, or weighted average rates or a range of rates may be presented for classes of financial instruments. If the effective interest rates differ substantially among instruments in a class (e.g., because the instruments are denominated in different currencies) the effective interest rate disclosure should be given for sub-groups. For floating rate instruments, a range of rates usually is disclosed.

The income statement of banks and similar financial institutions comprises mainly financial income and expense. IFRSs set out specific presentation and disclosure requirements for these types of entities. The presentation and disclosure for financial institutions is illustrated in KPMG's *Illustrative financial statements for banks*. This area of IFRSs may be subject to future developments (see 4.6.6).

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4.6.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In July 2004, the IASB published ED7 *Financial Instruments: Disclosures* proposing changes to the disclosures required for financial instruments. The proposal would replace and simplify some existing disclosure requirements of IAS 30 and 32 but would add a number of additional requirements, particularly in relation to credit risk, liquidity risk and market risk; sensitivity analysis and information provided to key management in relation to the management of risk and of capital.

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4.7 Income tax (current tax)

(IAS 12)

Overview

- **The total income tax expense recognised in the income statement is the sum of current tax expense (or recovery) plus the change in deferred tax liabilities and assets during the period, net of tax amounts recognised directly in equity or arising from a business combination that is an acquisition.**
- **Current tax represents the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.**
- **The measurement of current tax is based on rates that are enacted or substantively enacted at the balance sheet date.**

4.7.1 Recognition and measurement

The scope of IAS 12 is limited to income taxes, which are taxes based on taxable profits, as well as taxes that are payable by a subsidiary, associate or joint venture upon distribution to investors.

Taxes that are not based on taxable profits do not fall within the scope of the standard; examples include social taxes payable by an employer based on a percentage of an employee's wages, which are employee benefits (see 4.4), and taxes payable on capital and reserves. In our view, taxes that are excluded from the scope of IAS 12 generally should be accounted for in accordance with the guidance on provisions in IAS 37 (see 3.11). Issues related to the scope of IAS 12 are discussed further in 3.12.

Income tax comprises current tax (dealt with here) and deferred tax (see 3.12).

IAS 12.5, 58 The total income tax expense recorded in the income statement is the sum of current tax expense (income) plus the change in deferred tax liabilities and assets during the period, net of the following:

- amounts recognised directly in equity because they relate to items charged or credited, in the current or previous period, directly to equity (see 3.12 for further discussion and examples); and
- amounts arising from a business combination that is an acquisition (see 2.6).

IAS 12.12 A current tax liability or asset is recognised for income tax payable or paid but recoverable in respect of all periods to date.

IAS 12.46 As in the case of deferred tax, the measurement of current tax liabilities and assets is based on enacted or substantively enacted tax law, which in certain circumstances may include announcements of future changes; otherwise the effects of future changes in tax laws or rates are not anticipated (see 3.12).

4.7.2 Presentation and offsetting

IAS 1.68 Tax assets and tax liabilities should be presented separately from other assets and liabilities in the balance sheet. In addition, current tax assets and current tax liabilities should be distinguished from deferred tax assets and deferred tax liabilities on the balance sheet whether or not an entity chooses to present a classified balance sheet.

IAS 1.70 When an entity elects to present a balance sheet distinguishing between current and non-current items, it should classify current tax assets and current tax liabilities as current assets and current liabilities to the extent that they are payable or receivable within 12 months. If the current assets or

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liabilities are payable or receivable after 12 months from the balance sheet date, these amounts should be classified as non-current.

IAS 12.71

Current tax assets and current tax liabilities should be offset only when:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; this normally will be the case when the tax payable or receivable relates to income taxes levied by the same taxation authority and the taxation authority permits the entity to make or receive a single net payment; and
- the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Thus, within a group, current tax assets and current tax liabilities from different entities should be offset only if the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

4.7.3 Specific issues

While the concept of accounting for current tax is not difficult, issues arise with respect to dealing with specific tax regimes or schemes. This section considers some of these issues.

Restructured taxes

In some tax jurisdictions entities are able to negotiate the payment of large tax balances, so that the payment of amounts that ordinarily would fall due within 12 months under the tax legislation is deferred; typically a series of payments is negotiated with the tax authorities. When the restructured tax liability does not bear interest at a market rate, an issue arises as to whether the liability should be discounted to net present value at the date the terms of payment are agreed.

In our view, an entity should discount restructured tax liabilities on the basis that they are a financial liability (see 3.6). We believe that current taxes payable become a financial liability because of the contractual obligations arising from the specific negotiations between the entity and the tax authorities, and therefore the amounts due under the negotiated agreement would not be excluded from the scope of IAS 39.

Withholding taxes

IAS 12.52B, 65A

Any income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. Taxes on dividends imposed on the shareholders that the entity is required to withhold are recognised in equity as part of the distribution.

In our view, withholding taxes attributable to investment income (e.g., dividends received) should be recognised as part of income tax, with the investment income recognised on a gross basis. This is on the basis that neither the standard on revenue nor the standard on income taxes provides any mechanism for income tax paid to be offset against the underlying income.

Dividend credits

In some tax jurisdictions an entity may “attach” credits to a dividend payment that are used by the shareholder to offset tax payable on the dividend. The purpose of such credits is to provide relief from double taxation since the profits from which the dividend is paid have been taxed already at the entity level.

For example, in jurisdiction A shareholders are taxed on the gross amount of the dividend plus any credit attached, but then receive a deduction against tax payable for the amount of the credit; the statutory tax rate is 30 per cent. Entity B receives a dividend of 100 from entity C, with an “attached” dividend credit of 43 (calculated as 30/1 - 30 per cent).

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B's tax is calculated as follows:

	B
Dividend received	100
Dividend credit received	43
Taxable income	143
Income tax at 30 per cent	43
Less deduction	(43)
Tax payable	-

The issue for accounting purposes is how B should present the dividend received in the income statement, net or gross of the dividend credit:

	Net	*Gross*
Profit before tax	100	143
Income tax	-	(43)
Net profit	100	100

In our view, the net presentation is more appropriate because the dividend credit is simply a mechanism to ensure that certain dividends (or parts thereof) are tax-exempt. We believe that the net presentation reflects that substance.

Group tax

In many jurisdictions a parent and its subsidiaries can elect to be taxed on a group, rather than on an individual entity, basis. For example, entity D has a tax loss of 300 and fellow subsidiary E has a taxable profit of 300; the statutory tax rate is 30 per cent. For tax purposes the group has no taxable profit and therefore no tax is receivable or payable by either of the entities. The requirements of each specific jurisdiction will vary and accordingly the requirements for fund transfers between the group entities may vary. For example, either of the following could be required:

- E transfers to D an amount equal to the tax that would have been payable; and
- no payment is made by E.

The issue for accounting purposes is how such group tax arrangements should be presented in the financial statements of the individual entities or sub-groups.

An amount equal to the hypothetical tax is transferred between the entities

Continuing the above example, if E paid an amount of 90 (300 x 30 per cent) to D, the amount could be shown as either:

- revenue in D's income statement and operating expense in E's income statement; or
- income tax in both D's and E's income statements.

In our view, the "tax" payment should be recognised as part of income tax because this reflects the substance of the arrangement. Instead of E paying 90 to the tax authorities and D receiving 90 from the tax authorities, payment is made directly from E to D:

	D	*E*
Profit (loss) before tax	(300)	300
Income tax	90	(90)
Net profit (loss)	(210)	210

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No payment is made

Continuing the above example, in cases where no payment is made the group tax offset will be explained in the tax reconciliation (see 3.12):

	D	E
Profit (loss) before tax	(300)	300
Income tax	-	-
Net profit (loss)	(300)	300
Profit (loss) before tax	(300)	300
Tax at statutory rate of 30 per cent	90	(90)
Effect of group tax offset	(90)	90
Income tax	-	-

Foreign investment

Many jurisdictions provide tax relief for entities with an element of foreign ownership, which may be structured in a variety of ways. In general, as in the case of dividend credits (see above), when the result of a tax scheme is to reduce the effective tax rate attributable to certain income, in our view any benefit should be recognised as part of income taxes rather than as operating revenue.

For example, in jurisdiction F the statutory tax rate is 35 per cent. However, when a dividend is received from an overseas shareholder, that shareholder receives a cash rebate directly from the tax authorities of 20 per cent of the underlying taxes paid. This has the effect of reducing the effective tax rate on that dividend income to 28 per cent (35 x 80 per cent). Overseas shareholder G (who resides in jurisdiction F for tax purposes) receives a dividend of 100 from entity H, and thereby becomes entitled to receive a cash rebate of 7 (100 x 35 per cent x 20 per cent). In our view, G's income statement should be presented as follows:

	G
Profit before tax	100
Income tax	(28)
Net profit (loss)	72

If G was the parent of H, on consolidation we believe that the effect of the rebate should continue to be disclosed as part of income taxes since the overall effect is still to reduce the group's effective tax rate.

4.7.4 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Convergence project

The IASB and the FASB are considering their respective standards on accounting for income taxes as part of their convergence project. Both IAS 12 and the equivalent US standard SFAS 109 *Accounting for Income Taxes* are based on the balance sheet liability approach when accounting for deferred taxes. However, differences arise because both standards have many exceptions to their basic principle. The objective of this project is not to reconsider the underlying approach, but rather to eliminate exceptions to the basic principle. An exposure draft as a result of this convergence project is expected in the fourth quarter of 2004.

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4.8 Unusual or exceptional items

(IAS 1)

Overview

- **Significant items should be presented separately either in the notes or, when necessary, on the face of the income statement.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 1 *Presentation of Financial Statements*. The revised standard is effective for accounting periods beginning on or after 1 January 2005 and early adoption is encouraged. Where an existing requirement is discussed that will be changed by the revised standard, it is marked with a # and the impact of the changes is explained in the accompanying boxed text. In particular, the revised standard:

- does not require the presentation of results of operating activities (see 4.1); and
- prohibits the presentation or disclosure of items as "extraordinary".

4.8.1 Extraordinary items#

Forthcoming requirements

IAS 1.85 The revised standard makes no distinction between ordinary and extraordinary activities. Presentation or disclosure of items of income and expense net of tax or characterised as "extraordinary items" in the income statement or notes is prohibited.

4.8.2 Additional, unusual or exceptional items

Additional items

IAS 1.83, 84 Additional items are presented in the income statement or disclosed separately when relevant to an understanding of the entity's financial performance. Factors to consider when deciding whether to present or disclose additional items include materiality and the nature and the function of the components of income and expenses (see 4.1).

IAS 1.83, 84 Additional items should be described appropriately in accordance with their nature or function (consistent with the format adopted).

Identifying items as unusual or exceptional

IAS 1.15(c), 86 IFRSs do not describe events or items of income or expense as "exceptional" or "unusual" items.

In our view, an item is not exceptional merely because there is a requirement to provide separate disclosure of that item either on the face of the income statement or in the notes to the financial statements. Accordingly, in describing such items the term "exceptional items" should be avoided. Instead, we recommend that the nature of each item is described (e.g., disposal of a subsidiary or restructuring costs).

In our view, the description of items or events as exceptional should be infrequent and should be reserved for additional line items that justify a prominence greater than that achieved by separate presentation or disclosure. For example, it may be appropriate to characterise items such as costs associated with a natural disaster, or terminating or selling an entire operation, as unusual or exceptional items. When an item is characterised as "exceptional", in our view the description used also should include the nature of the item (e.g., exceptional loss on sale of an operation).

As no definition of "exceptional" exists in IFRSs, it is preferable for an entity to describe its use of the term in the notes to the financial statements and to apply that definition consistently.

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IAS 1.88

In our view, when classifying expenses by nature or function (see 4.1), exceptional amounts should be classified in the same way as non-exceptional amounts (see below under *Presentation and disclosure*).

IAS 1.15 (c), 84

Materiality is one factor to consider when deciding whether separate presentation of an item is necessary to an understanding of the entity's financial performance. In our view, in assessing the materiality of a potential exceptional item, the effect of the item as a whole should be considered, even if, for presentation purposes, it will be allocated to different line items.

Restructuring costs

Restructurings are not unusual and, in our view, generally should not be described as exceptional items. However, it may be appropriate to present the effect of a significant restructuring that clearly is distinct from the normal activities of the entity as an exceptional item (see 4.1).

Presentation and disclosure

Face of income statement or in the notes

IAS 1.29, 30

Note disclosure is sufficient for many additional items, including those identified as exceptional.

Separate presentation on the face of the income statement should be given only for very significant items when separate reporting is necessary for a fair presentation.

IAS 1.27, 29, 88

In our view, exceptional amounts generally should be presented together with or adjacent to non-exceptional amounts of the same nature or function (see 4.1). Classification of exceptional items as part of the same line item(s) as comparable non-exceptional items is necessary to comply with the requirements for consistent presentation and classification of items in the financial statements and for classification of expenses by nature or function. For example, exceptional items that are operating in nature (e.g., restructuring costs) should be included within the operating result sub-total (see 4.1). Similarly, significant impairment losses on investments should be classified in the same income statement sub-total as financial income and expense when the income or loss on these investments normally is included in that caption.

In our view, it is preferable to include a sub-total of all items with the same nature or function. For example, when both "Administrative expenses" and "Exceptional administrative expenses" are presented, a sub-total for the line item "Total Administrative expenses" also is presented.

When the effect of a particular event or circumstance is pervasive, affecting a number of line items, it may be appropriate to aggregate all related amounts and disclose in the notes to the financial statements the total impact of the exceptional event. In this case, in our view an analysis of individual line items should be disclosed in the notes, together with a description of the circumstances. An entity also may wish to disclose on the face of the income statement the exceptional element of each line item that is impacted. We believe that presentation of the effect of a particular event or circumstances as a single amount on the face of the income statement, which overrides the requirement to classify expenses either by nature or function, can by justified only in very rare cases.

Comparative information

When an exceptional item arises, it is possible that the relevant line item will contain both exceptional and non-exceptional amounts. Comparative amounts for that line item may contain only non-exceptional amounts. In our view, it is appropriate to analyse the line item and its comparatives into exceptional and non-exceptional amounts. This analysis may be given in the notes to the financial statements or on the face of the income statement. In our view, items that were not classified as exceptional in the prior period should not be reclassified in the current period.

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Presenting exceptional items of a similar nature or function in consecutive periods is inconsistent with characterisation of these items as unusual, non-recurring or otherwise outside the normal activities of the entity, unless the transaction spans over several financial periods.

4.8.3 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The Board's project on performance reporting is expected to affect significantly the presentation of items in the income statement. At this stage both the timing of the project and the nature of the changes are uncertain.

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5. Special topics

5.1 Leases

(IAS 17, SIC–15, SIC–27)

Overview

- **A lease is classified as either a finance lease or an operating lease.**
- **Lease classification depends on whether substantially all of the risks and rewards incidental to ownership of a leased asset have been transferred from the lessor to the lessee.**
- **Under a finance lease, the lessor recognises a finance lease receivable and the lessee recognises the leased asset and a liability for future lease payments.**
- **Under an operating lease, both parties treat the lease as an executory contract. The leased asset remains on the balance sheet of the lessor and the lessee recognises an expense for the lease payments over the lease term.**
- **Lessors and lessees recognise incentives granted to a lessee under an operating lease as a reduction in lease rental income / expense over the lease term.**
- **A lease of land generally will be classified as an operating lease unless title transfers to the lessee.**
- **Immediate gain recognition from the sale and leaseback of an asset is dependent upon whether the sale takes place at fair value or not, and upon the classification of the leaseback as an operating lease or a finance lease.**
- **A series of linked transactions in the legal form of a lease should be accounted for based on the substance of the arrangement; the substance may be that the series of transactions is not a lease.**
- **Special requirements apply to manufacturer or dealer lessors granting finance leases.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 17 *Leases*. The revised standard is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standard, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, under the revised standard a lessee may classify a property interest held under an operating lease as an investment property. If this is done, that interest is accounted for as if it were a finance lease.

5.1.1 Introduction

The accounting treatment for a lease does not depend on which party has legal ownership of the leased asset, but rather on which party bears the risks and rewards incidental to ownership of the leased asset.

IAS 17.4

A lease is an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments. The definition of a lease includes contracts that sometimes are referred to as hire or hire purchase contracts. While legal definitions of a lease, hire or hire purchase agreements may vary between different legal jurisdictions, IFRSs focus on

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the economic substance of the agreement. Therefore, lease accounting may be applicable to contracts that meet the definition of a lease under IFRSs, regardless of their legal name or definition. This area of IFRSs may be subject to future developments (see 5.1.8).

Under IFRSs each lease is classified as either a finance lease or an operating lease; the classification determines the accounting treatment to be followed by the lessor and the lessee.

A lease is considered to be a finance lease when substantially all of the risks and rewards incidental to ownership of the leased asset are transferred from the lessor to the lessee by the agreement. Typical indicators assessed to determine whether substantially all of the risks and rewards are transferred include the minimum lease payments that the lessee is required to make in contrast with the value of the asset at the inception of the lease, the duration of the lease in contrast with the economic life of the asset, and whether the lessee will obtain ownership of the lease.

Definitions

The definitions in IAS 17 are important in determining classification as a finance lease or as an operating lease. This classification is the basis for all subsequent accounting for the lease by both the lessee and lessor.

Minimum lease payments

IAS 17.4 Minimum lease payments are those payments that the lessee is, or can be, required to make to the lessor over the lease term. From the lessee's point of view, minimum lease payments also include residual values guaranteed by the lessee or a party related to the lessee. From the lessor's point of view, minimum lease payments also include residual values guaranteed by any third party unrelated to the lessor provided that party is financially capable of fulfilling the obligations under the guarantee. Both a lessee and a lessor also include in minimum lease payments the exercise price of a purchase option over the leased asset held by the lessee if it is reasonably certain at inception of the lease that the purchase option will be exercised. Minimum lease payments should not include contingent rent amounts, costs for services and taxes to be paid by and reimbursed to the lessor.

IAS 17.4 Amounts owed by a lessee to a lessor may include charges for repairs and maintenance or for other services. Similarly, the payments due under a lease may include charges that are reimbursements for expenditures paid by the lessor on behalf of the lessee (e.g., taxes, insurance). When there are service elements or other reimbursements included in a single payment, these elements must be separated from the minimum lease payments that relate to the right of use of the leased asset. When calculating the present value of minimum lease payments to evaluate lease classification, such service charges and reimbursements are excluded as they are not considered part of the minimum lease payments.

The allocation of the lease payment into the two components (right of use and other services / reimbursement) should follow the same principle as described in 4.2.

Inception versus commencement of a lease

IAS 17.4 The inception date of the lease is the earlier of the date of the lease agreement and the date on which the parties commit to the principal provisions of the lease contract. In our view, the commencement date of the lease is the date from which the lessee is entitled to exercise its right to use the leased asset. A significant amount of time may pass between the inception and commencement dates, for example, when parties commit to lease an asset that has not been constructed. In such cases, a calculation of the present value of minimum lease payments prepared to assist in determining the classification of the lease should cover the period from commencement of the lease (i.e., the calculation should not take into account the time value effect of the period between inception date and commencement date).

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Forthcoming requirements

IAS 17.4 The revised standard confirms the above approach; earlier versions of IAS 17 do not distinguish the date on which the lease commences from the inception date. Under the revised standard a distinction is made between the inception and commencement of the lease. The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

At this date:

- a lease is classified as either an operating or a finance lease; and
- in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. This is the date of initial recognition of the lease.

Recognition of the lease takes place at the commencement date based on the values at inception. However, if the lease payments are adjusted for changes in the construction or acquisition cost of the leased asset, general price levels, or the lessor's costs of financing the lease between the inception and commencement dates, the effect of such changes is deemed to have taken place at inception.

Lease term

IAS 17.4 The lease term commences when the lessee is *able* to start using the leased asset. This date may be earlier than when actual use begins. For example, the lease term for a retail property may commence on 1 May 2004 but the lessee needs to customise the interior of the property before opening and operating its retail store on 1 July 2004. Even if the tenant could not start customisation until 1 June 2004, the commencement date of the lease is 1 May 2004, because this is the date that the lessee is *able* to use the leased asset.

IAS 17.4 The lease term includes the *non-cancellable* period of the contract and also any further periods for which the lessee has an option to continue to lease the asset and, at the time of inception of the lease, it is judged reasonably certain that the lessee will exercise that option. For example, if the lease term is nine years but the lessee can cancel the lease without penalty at the end of the third and sixth year, the non-cancellable period of the contract would be three years.

IAS 17 does not provide specific guidance on how to assess when it should be considered "reasonably certain" that a lessee would exercise an option to renew the lease. The assessment of the degree of certainty should be based on facts and circumstances at the inception of the lease rather than being based on the lessee's intentions. In our view, if a lessee will be economically compelled to renew a lease, this indicates that renewal is reasonably certain.

Economic life versus useful life

IAS 17.4 A leased asset's *economic* life is the period over which the asset is expected to be usable (by the current and any subsequent lessee). The economic life is used when comparing the lease term to the asset's life when seeking to evaluate whether the lease is an operating or a finance lease. A leased asset's *useful* life, which may be shorter than its remaining *economic* life, is the remaining period over which the economic benefits of the asset are expected to be consumed by the lessee. A lessee depreciates an asset capitalised under a finance lease over the shorter of the *lease term* or the asset's *useful life*.

IAS 17.4 In our view, when an asset that previously was leased subsequently becomes the subject of a new lease, the economic life of the asset for the purposes of assessing the lease classification of the new lease is the *remaining* economic life of the asset measured from lease *commencement*. For example, a new asset with an economic life of 10 years was leased under a five-year lease. Following expiry of

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the initial lease, the lessor grants a new five-year lease over the remaining economic life of five years. The *economic* life for purposes of classifying the second lease is five years.

Residual values

IAS 17.4

There are two types of residual values to be considered by the parties to a lease contract: *guaranteed* residual values and *unguaranteed* residual values. A guaranteed residual value is the fixed or determinable amount that is required to be paid to the lessor at the end of the lease term or on disposal of the leased asset. An unguaranteed residual value is the amount that the lessor expects to recover from the leased asset following the end of the lease term; however realisation of that amount is not assured by a party external to the lessor.

The amount of the minimum lease payments reflects whether the residual values are guaranteed or unguaranteed. The lessor includes any guaranteed residual value in the determination of the minimum lease payments, while unguaranteed residual values are excluded from the minimum lease payments. The lessee only includes guaranteed residual values in the determination of the minimum lease payments if the lessee or a party related to the lessee guarantees the residual value.

Contingent rent

IAS 17. 4

Contingent rent is defined as that portion of lease payments that is "not fixed in amount". This definition specifically refers to *future* amounts that are not fixed because they are potential incremental payments linked to future changes in indices, sales, usage of equipment, etc. Lease payments that are based on a variable rate of interest or that are indexed to inflation are not themselves contingent rents; but the future changes (i.e., the incremental changes) in these lease payments resulting from changes in interest rates or inflation comprise contingent rents. The calculation of minimum lease payments includes the lease payments that are known as of the lease inception date, based on the then current variable market rate or current price level.

Initial direct costs

IAS 17.4, 38

Directly attributable costs often are incurred, by either the lessor or the lessee, in arranging a lease. These are referred to as "initial direct costs". Examples of initial direct costs include rental agents' commissions and legal fees. Items that are not considered to be initial direct costs include allocations of internal overhead costs, such as those incurred by a sales and marketing team.

The initial recognition of and the subsequent accounting for initial direct costs depends on the classification of the lease.

IAS 17.33, 34 (1997)

For a transaction that is a finance lease, a lessor either can recognise initial direct costs immediately in the income statement or it can allocate them against finance income over the lease term. A manufacturer or dealer lessor must recognise these costs as an expense in profit or loss at the inception of the lease#.

The lessee should include its initial direct costs in the amount recognised as an asset under the lease, which will affect the future depreciation of that asset.

For a transaction that is an operating lease, the lessor either should defer its initial direct costs and allocate them to income over the lease term in proportion to the recognition of rent income, or recognise them as an expense in the period in which they are incurred.

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Forthcoming requirements

IAS 17.20, 38, 42 Under the revised standard, for a transaction that is a finance lease, a lessor should include the initial direct costs in the initial measurement of the finance lease receivable. As a result the amount of interest income recognised over the lease term will be reduced. The interest rate implicit in the lease is defined in such a way that this is done automatically. There is no need to add these costs separately. The lessee must include its initial direct costs in the amount recognised for the asset under a finance lease, which will affect the future depreciation expense of that asset. A manufacturer or dealer lessor must recognise initial direct costs as an expense when the selling profit is recognised, which usually is at the commencement of the lease.

IAS 17. 52 Under the revised standard, for a transaction that is an operating lease, the lessor adds initial direct costs to the carrying amount of the asset under the lease and recognises them as an expense on the same basis as the lease income, which usually will be on a straight-line basis.

5.1.2 Classification of a lease

IAS 17.7, 8 A finance lease is defined as a lease that transfers substantially all of the risks and rewards incidental to ownership of the leased asset from the lessor to the lessee; title to the asset may or may not transfer under such a lease. An operating lease is a lease other than a finance lease. Risks include the possibilities of losses from idle capacity or technological obsolescence; rewards include the profitable operation over the asset's economic life and the gain from the increase in value of the asset or realisation of the residual value at the end of the lease.

IAS 17.13 The classification of a lease is determined at the inception of the lease and is not revised unless the lease agreement is modified.

Indicators of a finance lease

Primary lease classification criteria

IAS 17.10 The following are indicators that normally would lead to a lease being classified as a finance lease. Ultimately, the lease classification should be based on an overall assessment of which party to a lease bears substantially all the risks and rewards of ownership of the asset.

Transfer of ownership

IAS 17.10 If legal ownership of the asset ultimately transfers to the lessee, either during or at the end of the lease term, the agreement usually will be classified as a finance lease.

Purchase options

IAS 17.10 A purchase option that is expected, at inception of the lease, to be exercised means that title to the asset is expected to transfer. Therefore, a lease with such an option normally is classified as a finance lease. For example, if the lessee has the option to purchase the leased asset at a price that is expected to be sufficiently lower than the expected fair value of the leased asset at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercises, then the agreement should be classified as a finance lease. In our view, if a lessee will be economically compelled for business reasons to purchase the asset by exercising the option, and not just to take advantage of a below-market purchase option, this also indicates that the option is reasonably certain of being exercised.

Major part of economic life

IAS 17.10 If the lease term is for the major part of the economic life of the leased asset, the agreement normally would be classified as a finance lease.

IFRSs do not define what is meant by the "major part" of an asset's economic life. Practice has been to look to the lease accounting guidance in US GAAP which has quantitative criteria about what is considered to be the majority of an asset's economic life. US GAAP has a "bright-line" threshold whereby a lease term equivalent to 75 per cent or more of the economic life of an asset is

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considered to be the major part of the asset's economic life. Practice under US GAAP also permits a lease that is very close to, but below this bright-line cut-off (e.g., a lease term equivalent to 74 per cent of the asset's economic life) to be classified as an operating lease. In our view, while this quantitative bright line may be a useful reference point when seeking to interpret IFRSs, it does not represent an automatic safe harbour. We believe that it is necessary to consider all relevant factors when assessing the classification of a lease and it is clear that some leases may be for the major part of an asset's economic life even if the lease term is for less than 75 per cent of the economic life of the asset.

Present value of minimum lease payments equals substantially all of the fair value

IAS 17.10 If at the inception of the lease the present value of the minimum lease payments (as defined in 5.1.1) amounts to substantially all of the fair value of the leased asset, then the agreement normally would be classified as a finance lease.

IFRSs do not define what is meant by "substantially all". US GAAP has a bright-line threshold whereby if the present value of minimum lease payments is 90 per cent or more of the fair value of the leased asset at inception of the lease, then the lease must be classified as a finance lease. Practice under US GAAP also permits a lease that is very close to this bright-line cut-off (e.g., 89 per cent) to be classified as an operating lease. In our view, while the 90 per cent threshold may provide a useful reference point, it should not function as an automatic safe harbour under IFRSs.

In our view, the discount rate to be used in considering this reference point should be determined by applying the guidance in calculating the present value of minimum lease payments for the purposes of the lease classification test regarding the discount rate to be used when accounting for finance leases. Therefore, both the lessor and lessee should use the interest rate implicit in the lease as the discount rate for determining the present value of minimum lease payments. In many cases, the lessee will not have sufficient information about the unguaranteed residual value of the leased asset to determine the lease's implicit interest rate, in which case, we believe that the lessee should instead use its own incremental borrowing rate as the discount rate.

However, certain leases may, for example, have significant tax benefits which are reflected in the lease pricing such that the present value of the rentals, when discounted at the incremental borrowing rate, is less than 90 per cent of the fair value – not because the lessor has retained some asset risk but because the tax benefits are greater than 10 per cent. In these cases, judgement needs to be applied as to whether or not the lease transfers substantially all the risks and rewards incidental to ownership rather than reliance on such numerical tests.

Specialised nature of the asset

IAS 17.10 If a leased asset is so specialised that only the lessee can use it without major modification, then the agreement normally would be classified as a finance lease. An asset built to the specifications of the lessee may be a specialised asset. However, a machine that could be used by other entities in the same industry as the lessee (e.g., a printing press) would not be considered to be a specialised asset even if it had some degree of customisation.

Supplemental indicators of a finance lease

IAS 17.11 There are several additional indicators that a contract may be a finance lease. These are:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual fall to the lessee (e.g., in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); or
- the lessee can extend the lease at a rent that is substantially lower than the market rent.

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IAS 17.12 IAS 17 does not provide a hierarchy to be applied when evaluating the additional indicators discussed above, and these indicators may not be conclusive. If there are other facts or features that make it clear that the lease transfers substantially all risks and rewards incidental to ownership of the leased asset from the lessor to the lessee, then the lease should be classified as a finance lease. For example, in many long-term leases it is not uncommon for the lessee to have a cancellation right with some penalty payments. In our view, the calculation of the minimum lease payments should be based on the smaller of the non-cancellable lease payments plus the penalty or the total minimum lease payment.

Ultimately, the lease classification should be based on an overall assessment of which party to a lease bears substantially all of the risks and rewards of ownership of the leased asset.

Other classification issues

Probability-weighted evaluations of risks and rewards

IFRSs do not address how to consider probability when assessing whether a lease transfers substantially all of the risks and rewards incidental to ownership of an asset. One approach would be to make this assessment based solely on the relative proportions of total possible risks and rewards. Another approach would be to make this assessment on a probability-weighted basis. In our view, a probability-weighted basis should be used.

For example, an asset is leased for 14 years and has an estimated economic life of 20 years. The fair value of the asset at inception of the lease is 1,000 and its estimated residual value at the end of the lease term is 250. All risks and rewards of ownership are transferred to the lessee, M, other than the residual value risk.

M agrees to reimburse the lessor for the first 50 of losses on disposal of the asset at the end of the lease term (based on the estimated residual of 250). For example, if the asset is sold for 230, M will pay 20 to the lessor, R. If the asset is sold for 200 or less, M will pay 50 to R. M has an option to purchase the asset for 250, which is not a purchase option expected, at inception of the lease, to be exercised.

The present value of the minimum lease payments, *including* the guarantee of the first 50 of residual value, is 85 per cent of the fair value of the asset.

Historical data suggests that the residual value of the asset at the end of the lease term is highly unlikely to fall below 200. Therefore, all the "real" downside residual value risk is with M, as well as any potential gains over the estimated residual value of 250 as M would be able to exercise the option to purchase the asset for the fixed price of 250 if, at the end of the lease, the actual value was above 250.

In our view, the evaluation of transfer of risks and rewards should reflect the probabilities of the realistically likely range of outcomes. In this example, substantially all of the reasonably possible risks and a substantial majority of the rewards incidental to ownership of the asset are transferred to M. The lessor, R, has only an insignificant risk and no rewards in relation to the residual value. Therefore, in our view, the lease should be classified as a finance lease.

Leasing transactions undertaken via special purpose entities

Some leasing transactions may involve SPEs. In our view, when considering which of the lessor or the lessee bears substantially all of the risks and rewards incidental to the ownership of the leased asset, consideration should be given to the risks and rewards borne indirectly by the respective parties as a result of their association with the SPE. See 2.5 for further discussion of SPEs and structured transactions.

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Land and building leases

Because land normally has an indefinite economic life, a lease of land usually will be classified as an operating lease if the title does not pass to the lessee by the end of the lease and if the benefit of the residual value is not passed to the lessee by other means#.

Forthcoming requirements

IAS 17.15-17 Revised IAS 17 clarifies that, in the case of a combined lease of land and buildings, the revised standard requires the land and buildings to be considered separately to determine the classification, unless the value of the land at the inception of the lease is deemed immaterial. In determining the classification, the minimum lease payments at the inception of the lease are allocated to land and buildings in proportion to the relative fair values of the leasehold interests in the land element and the buildings element. If this cannot be done reliably, the entire lease is classified as a finance lease unless it is clear that both elements qualify as operating leases.

Long-term land leases

IAS 17.14 A lessee may acquire a long-term right of use of land for an up-front payment. If this long-term right does not transfer ownership of the land, the lease normally is considered to be an operating lease and the land is not recognised as an asset on the lessee's balance sheet. The up-front payment made to obtain the right to use the land would be capitalised as a lease prepayment and recognised over the lease term as an operating lease expense#.

Forthcoming requirements

IAS 17.19, 40.6 Under the revised standard, a lessee may elect to classify a property interest held under an operating lease as an investment property, if the property otherwise would meet the definition of an investment property (see 3.4), and if the lessee applies the fair value model to all of its investment property. This option is available on a property-by-property basis. If the lessee chooses this model, the lessee accounts for that interest as if it were a finance lease. For example, a lessee may acquire a 100-year ground lease that otherwise meets the definition of an investment property. In order to classify this leasehold interest as an investment property the lessee is required to use the fair value model when accounting for all of its investment property. The lessee must continue to account for the lease as a finance lease even if a subsequent event changes the nature of the lessee's interest so that it no longer is classified as investment property.

Multiple leased assets

In our view, the lease classification principles of IFRSs generally should be applied on an asset-by-asset basis when there are multiple assets covered by a single master lease arrangement. For example, a lessee may enter into an agreement to lease several buildings with varying economic lives and fair values. In our view, it would not be appropriate to determine a weighted average economic life for the group of buildings to compare to the lease term. Further, it would not be appropriate to compare the net present value of the lease arrangement's minimum lease payments to the total fair value of all of the buildings.

Subsequent changes to classification

IAS 17.13 Leases are not reclassified for changes in estimates (e.g., of the economic life or the residual value of the asset) or changes in circumstances (e.g., default by the lessee). If the terms of the lease are modified, the modified agreement may have to be treated as a new lease agreement, which may be classified differently from the original agreement. To determine whether a modification results in a new lease agreement, the test is whether the lease would have been classified differently if the modified terms had been in effect at the inception of the lease. If the modified terms would have resulted in a different classification based on the original estimates and circumstances, then the modified agreement is regarded as a new lease agreement and classified in accordance with its modified terms, based on estimates determined at the modification date.

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A lease is not reclassified due to a subsequent change in the likelihood that the lessee will renew a lease. For example, a lease may have a term of five years with a renewal option at the end of five years at a market rate. At inception of the lease, the lessee was not reasonably certain that the renewal option would be exercised and therefore, based its lease classification on the minimum lease payments and circumstances of the initial lease term only. If the lessee determines later that it is likely to renew the lease for an additional five years, this would not, of itself, change the lease classification.

5.1.3 Accounting for leases

Lessee

Finance lease

IAS 17.20 At inception of the finance lease, the leased asset and the lease liability are recorded at the lower of:

- the fair value of the leased asset; and
- the present value of the minimum lease payments. The discount rate to be used in determining the present value of the minimum lease payment is the interest rate implicit in the lease. The minimum lease payments include the exercise price of options expected, at inception of the lease, to be exercised and known increases (see 5.1.1 under *Contingent rents*).

The interest rate implicit in the lease is the discount rate at which the aggregate of the present value of the minimum lease payments and any unguaranteed residual value equals the fair value of the leased asset#. If the rate implicit in the lease cannot be determined, the lessee's incremental borrowing rate is used. Initial direct costs incurred are capitalised as an addition to the cost of the asset as determined above.

Forthcoming requirements

IAS 17.4 Under the revised standard, initial direct costs are included in the calculation of the interest rate implicit in the lease, rather than being capitalised separately. The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

IAS 17.25 The periodic lease payments should be split into two components: the interest charge for the period and the reduction (redemption) of the lease liability. The interest charge should be determined so that a constant periodic *rate* of interest is recognised on the outstanding balance of the liability. Interest and redemption are determined on an annuity basis, whereby the interest *amount* generally decreases over the lease term and the redemption amount generally increases each period.

In our view, subsequent accounting for the asset under a finance lease should be similar to other owned assets, and assets under finance leases cannot be considered to be a separate class of assets solely on the basis that they were acquired under finance leases. For example, if a lessee has an accounting policy whereby all property, plant and equipment is revalued (see 3.2), this policy also should be applied to similar assets leased under finance leases.

IAS 17.27 The asset under a finance lease should be depreciated in accordance with the depreciation policy used for comparable owned assets (see 3.2), over the shorter of the period of the expected use of the asset and the lease term. However, if at inception of the lease it is reasonably certain that the lessee will obtain the (legal) ownership of the asset by the end of the lease term then the asset should be depreciated over the expected useful life of the asset.

IAS 17.29 The reduction of the lease liability is recognised based on an effective (constant) rate of interest method. However, depreciation of the asset is recognised on a different basis (e.g., straight-line – see 3.2). Consequently, the amounts included in the balance sheet for the leased asset and the related liability are unlikely to be equal after inception of the lease.

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Operating lease

A lessee under an operating lease does not recognise the leased asset on its balance sheet, nor does it recognise a liability for rentals in respect of future periods.

IAS 17.33 A lessee under an operating lease recognises rent expense on a straight-line basis over the lease term (i.e., between the commencement date and the end of the lease term), or another systematic basis if it is more representative of the pattern of benefits to the lessee. Generally, this will result in the recognition of prepaid rent or accrued liabilities for rental payments.

Operating lease incentives

SIC 15 Sometimes lessors provide incentives for the lessee to enter into a lease agreement; such incentives may include the reimbursement of relocation costs or costs associated with exiting existing lease agreements, or initial periods that are rent-free or at a reduced rate. These incentives are an integral part of the net consideration agreed for the use of the asset. Incentives granted to the lessee to enter into the operating lease should be spread over the lease term using the same recognition basis as the rental payments.

If, for instance, a rent-free period of two years is agreed in a lease agreement covering 10 years at an annual amount of 1,000 for years three to 10, the lessee (and the lessor) would recognise the net consideration of 8,000 systematically over the 10-year lease term. Alternatively, if a lease agreement is for 10 years and the annual lease payment equals 800 in the first five years and 1,000 in years six to 10, the lessee (and the lessor) would recognise the net consideration of 9,000 systematically over the 10-year lease term. Assuming that the benefit is the same in each of the 10 years, the lessee would recognise rent expense of 900 in the first year and accrued rent of 100 at the end of the first year, while the lessor would recognise 900 of lease income and 100 of accounts receivable.

In some jurisdictions where longer-term leases are commonplace, there may be periodic rent reviews to adjust the lease payments up to the prevailing market rates. In our view, for leases that are subject to these periodic adjustments, the lease incentive, if any, should be spread over the the *entire* lease term rather than the shorter period until the next market adjustment.

Lessor

The definitions of finance and operating leases are the same for lessors as for lessees. However, the definition of minimum lease payments for a lessor also includes any residual value guaranteed by a financially capable independent third party, whereas the lessee includes only amounts guaranteed by the lessee and parties related to the lessee.

Finance lease

IAS 17.36, 37 Initially the lessor records a finance lease receivable at the amount of its net investment, which comprises the present value of the future minimum lease payments receivable and any unguaranteed residual accruing to the lessor. The present value is calculated by discounting the gross amounts due, at the interest rate implicit in the lease (see above), and then adding capitalised initial direct costs, where applicable (see 5.1.1)#.

IAS 17.39 Over the lease term the lessor accrues interest income on the net investment. The receipts under the lease are allocated between reducing the net investment and recognising finance income, so as to produce a constant rate of return on the net investment.

Forthcoming requirements

IAS 17.4, 17.38 Under the revised standard, initial direct costs are included in the finance lease receivable, rather than being capitalised separately, unless the lessor is a manufacturer or dealer (see below). The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

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Manufacturer or dealer lessors

IAS 17.34, 35, 38 (1997)

In some industries (e.g., office products, automotive), manufacturers or dealers often act as lessors of their products, either directly or through a finance entity subsidiary. A finance lease of an asset by a manufacturer or dealer results in two types of income: (1) initial selling profit and (2) finance income over the lease term. Manufacturer or dealer lessors recognise the selling profit or loss in the income statement for the period in accordance with the entity's normal accounting policy for outright sales. Initial direct costs are recognised as an expense in the income statement at the inception of the lease.

IAS 17.45

If manufacturer or dealer lessors quote below-market interest rates (e.g., as a marketing tool), selling profit is restricted to that which would have been earned if a market rate of interest was charged. Using the lower rate would not be appropriate since it would overstate the selling profit and understate the financial income in subsequent periods.

Operating lease

IAS 17.49

A lessor under an operating lease recognises the leased asset on its balance sheet. Generally, future contractual rental payments from the lessee are recognised as receivables over the lease term as the payments become receivable. The asset subject to the operating lease should be presented in the lessor's balance sheet according to the nature of the asset (e.g., equipment).

IAS 17.44 (1997)

Initial direct costs incurred by the lessor in arranging an operating lease either are deferred and allocated to income over the lease term in proportion to the recognition of rent income, or recognised as an expense in the income statement in the period in which they are incurred#.

Forthcoming requirements

IAS 17.52

Under the revised standard, initial direct costs incurred by the lessor in arranging an operating lease must be included in the carrying amount recognised for the leased asset and cannot be recognised immediately as an expense. These initial direct costs are recognised as an expense on the same basis as the lease income. This will not necessarily be consistent with the basis on which the leased asset is depreciated.

IAS 17.53

The lessor must depreciate the asset subject to the lease over the asset's useful life in a manner that is consistent with the depreciation policy the entity applies to similar owned assets (see 3.2).

Annuity depreciation

"Annuity depreciation" refers to depreciation methods under which the depreciation charge is adjusted to reflect the time value of money. Such depreciation methods result in lower depreciation charges in initial periods, and larger depreciation amounts in later periods. These methods are used under some national accounting practices by lessors in order to recognise a level profit, after considering financing costs related to the leased asset, over the lease term. In our view, the financing costs of an asset should not impact the selection of a depreciation policy. IFRSs require depreciation to reflect the consumption of the economic benefits of an asset. We believe that this does not extend to consideration of financing costs or inflation adjustments.

Lease income recognition by the lessor

IAS 17.39

For a finance lease, the lessor recognises income on a pattern that reflects a constant periodic rate of return on the lessor's net investment outstanding.

IAS 17.50, SIC 15

For an operating lease, generally the lessor recognises income on a straight-line basis over the lease term. It may be possible to recognise lease income using another systematic basis if that is more representative of the time pattern in which benefits from the leased asset are consumed.

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Incentives granted to the lessee to enter into the operating lease should be spread over the lease term using the same recognition basis as the lease income.

Similarly an escalation of rental payments over a period of time should be reflected in the determination of the lease income which is recognised on a straight-line basis. For example, a contractual three per cent per annum escalation of rents over the lease term should be anticipated from commencement of the lease. The result is that more lease income is recognised in early periods than cash lease payments received, and in later years the opposite would occur. *Contingent* rents (as defined in 5.1.1) should not be included in the determination of lease income, which is recognised on a straight-line basis.

5.1.4 Other issues

Contingent rent

Contingent rent should be included in profit or loss using the same classification as for non-contingent rental income or expense. For example, a lease payment may be partially fixed with additional rent based on total sales volume generated at the leased property. In our view, the fixed and contingent rent should be included in the lessee's operating expense. In our view, while it might be appropriate to consider the contingent rent amount as a cost of sales, it would not be appropriate to present this as a reduction of sales revenue in the lessee's financial statements.

IAS 34.B7 Often, leases to retailers include contingent rental payments such as one per cent of sales in excess of 5,000,000 but less than 10,000,000, and two per cent of sales of 10,000,000 or more. Limited guidance is provided in the interim reporting standard on a lessee's accounting for contingent lease obligations (see 5.9). That standard requires recognition of an obligation before the minimum sales level is met if the required level of sales (5,000,000 and 10,000,000 in the example above) is expected to be met over the measurement period for which rent payments are calculated.

In our view, this approach should be applied in both interim and annual financial statements. Therefore, a lessee would recognise lease expense based on the lessee's best estimate of expected total payments.

In our view, lessors should recognise contingent rent income on a basis consistent with the lessee's recognition of a liability for contingent rental obligations. Therefore, if a lessor concludes that, in the above example, the lessee's total sales will be 8,000,000 for the lease year, then 30,000 ((8,000,000 - 5,000,000) x one per cent)) of contingent rental income should be accrued over the lease period.

Derecognition of finance lease receivables

IAS 39.2(b) The derecognition of finance lease receivables is covered by the general derecognition guidance in the financial instruments standards (see 3.6). In order for lease receivables to qualify for derecognition by the lessor, in full or in part, the transfer of the lease receivables needs to meet the derecognition criteria specified in the financial instruments standards. Depending on the level of risks and rewards transferred and the continuing level of involvement by the transferor, the transaction could result in full derecognition, partial derecognition or no derecognition of the transferred lease receivables.

Netting finance lease receivables refinanced on a non-recourse basis

If a lessor finances its net investment on a non-recourse basis then netting, which effectively is derecognising (part of) the net investment, would be appropriate only if the arrangements transferred the contractual rights to receive the cash flows of (part of) the lease receivable to the provider of finance, or resulted in the lessor assuming an obligation to pay these cash flows to the provider in terms of a qualifying pass-through arrangement. In our view, this is unlikely with simple non-recourse finance.

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Derecognition of finance lease payables

IAS 39.2(b) Finance lease payables recognised by a lessee are subject to the derecognition provisions of the financial instruments standards (see 3.6). Finance lease payables should be derecognised only when the lessee's obligation in terms of the lease contract is extinguished, discharged, or cancelled, or when it expires.

Embedded derivatives

IAS 39.2(b) If a lease contract contains terms or conditions with the characteristics of a derivative instrument, the parties to the lease contract must evaluate whether this embedded derivative component of the lease needs to be split out from the lease contract and accounted for separately (see 3.6). Examples of terms that may require separate recognition of an embedded derivative include leverage features built into the lease payments, or lease payments that are based on an index that is unrelated to the lease contract.

Impairment

IAS 17.30, 54 Impairment of assets under an operating lease is dealt with in the same manner as impairment of other non-financial assets (see 3.9). In the case of an operating lease, impairment of the leased asset would be relevant to the lessor. Impairment of the asset under a finance lease would be relevant to the lessee.

IAS 39.2(b) For a finance lease, the lessor recognises lease receivables rather than the leased asset itself. As the nature of lease receivables is similar to that of loans, the lessor should apply the financial instruments standards to determine whether there is any impairment of the receivables that must be recognised (see 3.6). In a finance lease, the lessor's primary risk is exposure to the creditworthiness of the lessee as opposed to potential decreases in value of the leased asset.

Tax issues in finance leases

After-tax methods of recognising finance income

As noted above, a lessor recognises finance income from finance leases based on a pattern reflecting a constant periodic rate of return on its net investment in the lease. In our view, this calculation must be based on the book value of the net investment. The lessor may not adjust finance income to achieve a constant rate of return on the net *cash* investment, and thereby recognise a constant rate of return on an after-tax basis. IAS 17 does not specifically prohibit use of the net cash method. However, while recognition of finance income based on the net cash investment previously was permitted by IFRSs, that option was removed in the 1997 revisions to IAS 17.

A finance lease may have significant tax benefits that are considered in the pricing of the lease transaction. This could result in a situation where the finance income from the lease is negative due to the present value of the minimum lease payments being less than the cost of the leased asset. On a pre-tax basis the lease results in a loss. However, on an after-tax basis the lease would be profitable. In our view, the accounting loss should be spread over the lease term and recognised in line with the net investment in the lease. We believe that the loss should not be recognised immediately.

Tax variation clauses

Some finance leases allow the lessor to obtain a tax benefit which is passed to the lessee in the form of reduced lease rentals. Virtually all such lease agreements contain a tax variation clause. Normally these clauses are structured so that any tax disadvantage suffered by the lessor as a result of a change in tax rates or rules will be compensated by an increase in future lease payments.

IFRSs do not have any guidance regarding the triggering of tax variation clauses. For example, the lessor may view the triggering of the tax variation clause as a contingency and recognise the contingent cash flows on a prospective basis over the remaining life of the lease. Alternatively, the lessor may determine that the trigger should be treated as a "catch up" in profit or loss. In our view,

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the method applied by the lessor should reflect the nature of the clause and whether the effect of the tax change is retrospective or prospective. The approach adopted for each type of variation clause should be applied consistently.

For example, lessor T borrows 1,000 at six per cent to purchase an asset. The asset is leased under a 20-year finance lease at an implicit interest rate of five per cent. T is able to earn a small profit because tax cash flows allow T to repay the borrowing before the end of the lease term, generating interest cost savings.

After 10 years the tax legislation changes, and T is required to reimburse the tax authorities for the full amount of tax benefits previously obtained, including interest. Under the tax variation clause, the lease income over the remaining 10 years of the lease increases to seven per cent. Over the entire lease term, T achieves a return of six per cent, the rate that would have applied to a loan with no particular tax advantages.

There are three possible ways to account for the triggering of the tax variation clause:

- prospectively, recognising future lease income at seven per cent;
- retrospectively, by restating the net investment in the lease, with a credit to income at the "trigger" date, either:
  - by discounting future lease rentals at five per cent (the original rate implicit in the lease); or
  - by discounting future lease rentals at six per cent (the rate that would have applied had the tax benefit never been available to the lessee).

If the additional rentals are considered as "contingent rent" then the additional rental payments should be recognised prospectively, once the lessee is obligated to make them. Retrospective adjustment as described in the third alternative would be consistent with viewing the net investment in the lease as a financial asset and applying the guidance for changes in cash flow estimates under the effective yield method used to calculate returns on financial assets (see 3.6). The third alternative results in the matching (to a degree) of the tax cost incurred by the lessor at the trigger date with the reimbursement of the related tax benefits recovered from the lessee.

In practice, tax variation clauses may take many forms. Changes in tax legislation also can take many forms. In some cases rentals would be adjusted for any change in the tax rate applied to T, in others, T's tax benefit may be removed or adjusted prospectively. In our view, the first method generally should be applied, following a "contingent rent" approach. However, when it can be demonstrated that the effect of the clause is to reimburse T for the retrospective removal of a tax benefit that was contemplated in the original pricing of the lease, the second method may be appropriate. The third method has the effect of recognising future income at the date that the change in future terms comes into effect, and, in our view, would not be appropriate.

5.1.5 Sale and leaseback transactions

A sale and leaseback transaction consists of two elements: the sale of the asset from the seller to the lessor, and the leaseback of the asset from the buyer / lessor to the seller / lessee.

Under IAS 17 the two "legs" of the sale-leaseback each are accounted for rather than the seller / lessee accounting for the net effect of the combined transaction.

IAS 17.4, 59 For example, a sale and leaseback transaction may result in a leaseback that is classified as a finance lease. IAS 17 requires sale and finance leaseback transactions to be accounted for as a sale and a lease even though the net effect of the two transactions is that the seller retains substantially all of the risks and rewards of the asset and therefore, the net effect of the transaction as a whole would not satisfy the revenue recognition criteria in IFRSs (e.g., for sales of real estate (see 4.2)).

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In our view, because IAS 17 bypasses the assessment of the "sale" transaction against the revenue recognition criteria, the classification of the leaseback as an operating or finance lease should reflect not only the terms of the "lease" but also the risks and rewards retained by the seller / lessee under the "sale" agreement.

IAS 17.58 In a sale and leaseback transaction, the periodic lease payments usually are highly dependent on the sale price of the asset. The accounting for the gain (or loss) on the sale leg of the transaction depends in part on the classification of the leaseback.

Sale and finance leaseback

IAS 17.59 When a sale and leaseback results in a finance lease, any gain on the sale is deferred and recognised as finance income over the lease term. No loss is recognised unless the asset is impaired.

Sale and operating leaseback

IAS 17.61 If the leaseback is classified as an operating lease, any gain is recognised immediately if the sale and leaseback terms clearly are at fair value. Otherwise, the sale and leaseback are accounted for as follows:

- If the sale price is at or below fair value then the gain or loss is recognised immediately. However, if a loss is compensated for by future rentals at a below-market price, the loss is deferred and amortised over the period that the asset is expected to be used. In our view, the loss that is deferred cannot exceed the amount equal to the difference between the below-market lease terms and a fair market rental at inception of the lease.
- If the sale price is above fair value then any gain is deferred and amortised over the useful life of the asset.
- If the fair value of the asset is less than the carrying amount of the asset at the date of the transaction then that difference should be recognised immediately as an impairment loss.

5.1.6 Linked transactions in the legal form of a lease

SIC 27 A series of linked transactions that are in the legal form of a lease should be accounted for in accordance with their economic substance. This situation may occur, for example, when a transaction is in the form of a lease but does not transfer the right of use of the asset from the lessor to the lessee. These transactions may be entered into in order to generate a tax savings (often cross-border) or to generate fees. Transactions in the legal form of a lease are considered to be "linked" when the individual transactions cannot be understood without reference to the series as a whole. In this case, the series of transactions should be accounted for as one transaction. Therefore, the net effect of the transaction is accounted for, rather than accounting separately for each leg of the transaction.

Lease transactions not in the form of a lease

Sometimes the right to use an asset may be transferred in an agreement for the supply of goods or services (or both) that is not characterised as a lease. In our view, when the substance of such an arrangement is, or includes, a lease, then lease accounting should be applied.

For example, a manufacturer may enter into a long-term power supply contract, under which a "supplier" is required to construct a generator to the manufacturer's specification and the manufacturer commits to pay for all, or substantially all, of the potential output of this generator for 15 years. The manufacturer agrees to pay a fixed monthly payment and a variable payment, with the variable payment relating to actual operating costs.

In our view, this power supply agreement includes a lease agreement for the generator, and the portion of the agreement that represents the lease should be accounted for under IAS 17.

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This area of IFRSs may be subject to future developments (see 5.1.8).

5.1.7 Presentation and disclosure

IAS 32.7 Lease receivables and lease payables are financial instruments and are treated as financial instruments for disclosure and presentation purposes (see 5.6).

For operating leases, a lessee presents its lease payments as operating expenses in the income statement. A lessor presents the lease payments received as part of revenue in the income statement. In our view, a lessee may not split out a finance component of its operating lease payment to present that component as part of interest expenses.

IAS 17.31, 35, 47, 56 In addition, lessors and lessees must provide a general description of significant leasing arrangements. For lessees this should include information on the basis on which contingent rent payments are determined, the existence and terms of renewal or purchase options, and escalation clauses and restrictions imposed by lease arrangements, such as those concerning dividends, additional debt and further leasing.

IAS 17.35, 56 For operating leases, both the lessor and the lessee should disclose the non-cancellable minimum lease payments to be received or paid, respectively, over the remaining term of the lease.

5.1.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In January 2004, the IFRIC issued draft interpretation IFRIC D3 *Determining Whether an Arrangement Contains a Lease* addressing rights of use. The arrangements in question may or may not be contractual, but convey a right to usage, capacity or output from a specified asset. The interpretation is related to the scope of IAS 17 and does not establish new classification or measurement principles for arrangements that are, or contain, a lease.

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5.2 Segment reporting

(IAS 14, IAS 36)

Overview

- **Segmental disclosures are required for entities whose equity or debt securities are publicly traded, or that are in the process of issuing such securities.**
- **Segmentation is based on the dominant source and nature of an entity's risks and returns as well as the entity's internal reporting structure.**
- **Information should be reported for both business segments and geographical segments.**
- **One basis of segmentation is primary and the other is secondary, and less information is required to be disclosed for secondary segments.**
- **The amounts disclosed are based on amounts in the financial statements.**
- **Comparative information normally is restated for changes in reportable segments.**

5.2.1 Scope

IAS 14.3

Disclosure of segment information is required only by those entities with publicly traded equity or debt securities, or those that are in the process of issuing such securities. Other entities are encouraged, but not required, to disclose segment information. Segment disclosures should be within the financial statements.

"Publicly traded" is not a defined term in IFRSs. In our view, if a buyer or a seller can contact a broker and obtain a quoted price, the shares or potential shares should be regarded as publicly traded. This is without regard to how often the share is traded.

Segment information also is required when an entity is in the process of issuing listed securities. In our view, segment information will be required only when the entity has taken active steps to obtain a listing, rather than simply planning the listing. When an entity prepares a prospectus in preparation for listing, segment information should be included in the prospectus.

IAS 14.5

Where an unlisted entity wishes to provide segment information, but is unable to obtain all of the required information, or wishes to disclose only limited information, the segment information should be presented outside of the financial statements, for example, as part of the management discussion and analysis. In our view, where appropriate the entity should indicate that it has prepared the information in accordance with IAS 14 except that certain disclosures (which should be identified) have been omitted.

5.2.2 Identification of reportable segments

IAS 14.9

Segments are distinguishable components of the entity (either business components or geographical components) that are subject to risks and returns that are different from those of other components.

IAS 14.26

Two types of segments normally are identified: Primary segments (in respect of which detailed disclosures are required) and secondary segments (for which less detail is required).

IAS 14.26, 27

The dominant source and nature of an entity's risks and returns determines whether its primary segment reporting is based on business or geographical segments. Usually this is established from the entity's internal organisational and management structure and its system of internal financial reporting to the directors and chief executive. If internal financial reporting is based on neither business nor geographical segments, the entity selects either business segments or geographical

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segments as its primary segment reporting format. However, if the risks and returns are affected strongly by both differences in its various products or services *and* its various geographical areas of operation, then the primary segment reporting is based on business segments. In such cases, the entity may consider it useful to present voluntarily the same level of information for its secondary (geographical) segments.

Determining the composition of segments and the number of reportable segments requires considerable judgement. In making this evaluation, the entity should consider its objectives for providing segment information. Information about an entity's different products and services, as well as its operations in different economic environments, is relevant to assessing the risks and returns of diverse entities as the segments are subject to differing rates of profitability, growth, future prospects and risks. This often is not determinable from the aggregated financial information of the entity.

If an entity determines that it operates as only one segment (both in terms of business and geography), no segmental reporting is necessary other than a note disclosing that there is only one segment.

In our view, before concluding that an entity has only a single business or geographic segment, it should carefully consider *all* relevant factors, including, but not limited to:

- its internal organisational and management structure and its system of internal financial reporting;
- whether its products include a combination of goods and services, and whether these constitute different segments; and
- differences between seemingly similar products, for example, variations in gross margins or focus of products on specific markets or industries.

In some cases, an entity may operate in a particular industry but have a single business unit operating in a different industry. For example, B is primarily an industrial entity and has a business unit which provides short-term insurance services to parties external to the group. In determining its reportable segments, the group considers whether it should report the insurance business unit as a separate segment. It may need to consider whether to report the insurance business as a single segment or as multiple reportable insurance segments (e.g., property cover, health cover, etc.). The group should consider the materiality of this business unit in the context of the group, as well as the risks and returns of each insurance line of business and whether they differ.

IAS 14.34-36

A reportable segment is any segment identified that earns the majority of its revenue from external customers, and that accounts for 10 per cent or more of the entity's revenue, results of operating activities (in absolute terms) or total assets. If it is below the size threshold, an internally reported segment may be:

- designated as a reportable segment despite its size;
- combined with other segments if they have similar long-term performance and are similar in respect of a number of detailed factors; or
- included as an unallocated reconciling item.

An entity may choose to identify an internally reported segment as reportable despite it not meeting the size thresholds, for example, if the entity plans to expand the segment or if the market performance of the segment has been volatile over previous years.

IAS 14.34

Combining segments is permitted when two or more segments are substantially similar, but is not mandatory.

In our view, subject to the requirements to include segments that exceed the size criteria, entities should be consistent from period to period in identifying and presenting segmental disclosures.

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IAS 14.34-37 The total external revenue attributable to reportable segments must exceed 75 per cent of the total consolidated or entity revenue. In other words, the external revenue that is not attributed to a reportable segment must be less than 25 per cent. If this is not the case, additional segments must be identified. These additional segments need not meet the general size thresholds (i.e., that they account for 10 per cent or more of the entity's revenue, results of operating activities (in absolute terms) or total assets). Additional reportable segments are identified until the 75 per cent threshold is reached.

For example, E identifies geographic segments as its primary segment reporting format. It has one internally reported segment comprising 70 per cent of the total external revenue and six others, each comprising five per cent of the total external revenue. Three of the segments are considered to be substantially similar to each other, and the other three also are considered to be substantially similar. There are a number of ways that E could meet the requirement that total external revenue attributable to reportable segments must exceed 75 per cent of total revenue. They include:

- choosing to identify at least one other segment as reportable despite it not meeting the size thresholds;
- combining similar segments to form one (or more) reportable segments; or
- a combination of the two approaches described above.

Any segments not included in a reportable segment are disclosed as an unallocated reconciling item.

In our view, disclosure should be provided when reportable segments do not meet the size thresholds (as in the first alternative) and also of the composition of reportable segments when substantially similar segments have been combined (as in the second alternative).

Consideration of geographical segments

IAS 14.13 The risks and returns of an entity are influenced by:

- the geographical location of the entity's production or service facilities and other assets (when its products are produced or service delivery activities are based); and
- the location of its markets and customers (where its products are sold or services are rendered).

The location of an entity's customers may differ from the location of its assets. Determining the most appropriate basis of geographical segment reporting will depend on the entity's internal reporting structure.

For example, T is an entity domiciled in the United States, with a factory that is located in Hong Kong. Sales from this factory are negotiated on behalf of T by a sales office that is located in the United Kingdom. Customers of the UK sales office are located throughout Europe.

If geographical segments are determined based on the location of the entity's customers or markets, segments representing each region or country in Europe will be identified. The factory assets that are used to manufacture the product normally would be allocated to the segments on a reasonable basis. For example, the property, plant and equipment may be allocated based on proportions of total sales or on actual use of the machines.

If, however, geographical segments are determined based on the location of operations, the location of the entity's production facilities is the factory in Hong Kong and it is likely that there would be only one geographical segment. All other assets and liabilities would be attributed to this segment, including assets of the UK sales office and the related trade receivables.

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Vertically integrated operations

IAS 14.35-40

IAS 14 limits the required disclosure of reportable segments to those segments that earn a majority of their revenue from sales to external customers. The standard encourages, but does not require, different stages in vertically integrated operations to be identified as separate business segments, with appropriate description (including disclosure of the basis of inter-segment pricing).

For example, entity A has a number of business segments, including a new technology (NT) segment which includes certain early stage research and development expenditure to develop new business opportunities both within and beyond the current scope of one of its business segments. The NT segment earns the majority of its revenue from internal customers and most of its products are passed to another business segment. NT is considered to be a vertically integrated activity for A.

The entity could present NT as a separate segment even though it does not generate a majority of its revenue externally. Alternatively, if there is a reasonable basis for combining NT and a related business segment, this may be done.

In contrast, now assume that NT is a stand-alone research unit that is focused on a particular business segment, rather than a research and development group that supports all of A's ongoing businesses. In this case, NT may be considered to be part of a particular business segment, in which case separate segmental disclosure of the research group may not be required. On the other hand, if NT supported *all* of A's ongoing businesses, it is more likely that NT would be considered to be a corporate activity.

In determining whether an internally focused segment is considered to be vertically integrated with another, or whether it supports more than one segment, an entity should consider its policy for allocation of internal costs, for example, whether the costs incurred by the internal segment are allocated only to a single segment or to more than one segment (see 5.2.3).

In some cases, it may not be appropriate to report an internally reported segment separately as it may be an integral part of another segment, rather than the two segments being considered to be vertically integrated activities. For example, a postal company, C, maintains a large number of post offices. The post offices sell various services that are offered by the postal company, the primary service being the distribution of mail and other services being minor and incidental. In our view, the post office segment is an integral part of the mail segment, as one cannot function without the other.

5.2.3 Definition of segment assets or liabilities and income or expenditure

IAS 14.16-21

An item of revenue, expense, asset or liability is allocated to a segment when it is directly attributable to a segment or it can be allocated to a segment on a reasonable basis. An entity's internal reporting system is the starting point for identifying items that can be attributed directly or allocated to segments on a reasonable basis. For example, the way costs that are incurred at the group level on behalf of segments are allocated to the segments may be a good starting point, if this is done on a reasonable basis. The group policy and basis for charging internal services and transfers also should be considered.

IAS 14 does not assume that *all* assets / liabilities and income / expenses of an entity will be allocable to the reportable segments, as it only allows assets and liabilities that relate to the operations of the segment to be allocated to the segment.

IAS 14.47, 48

When income or expense arising from an asset or liability is included in segment revenue or segment expenses, related assets or liabilities also are included in that segment's reported assets or liabilities. When assets are used jointly by two or more segments, these assets are allocated to the segments if their related revenues and expenses also are allocated to those segments. For example, if the segment result measured for internal reporting includes depreciation, the related property, plant and equipment should be included in segment assets.

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The way in which assets, liabilities, revenue and expenses are allocated to segments will vary between different entities, and depends on factors such as the nature of those items, the activities conducted by the segment and the relative autonomy of that segment. IAS 14 does not require an entity to allocate jointly used assets and liabilities if the allocations would be arbitrary and not understandable.

IAS 14.20 Segment result is intended to be a measure of the operating profit of a segment, rather than of profit net of interest and / or tax. Therefore, borrowings and similar liabilities and the related expenses generally are not allocated to reportable segments unless the operations are primarily financial in nature. Items that generally will not be allocated to segments include:

- interest expense (including interest incurred on advances and loans from other segments) and the related debt, unless the segment's operations are primarily of a financial nature;
- interest or dividend income (including interest earned on advances or loans to other segments), and the related assets, unless the segment's operations are primarily of a financial nature;
- gains or losses on the sale of investments or extinguishment of debt, unless the segment's operations are primarily of a financial nature;
- income taxes and the related tax assets and liabilities;
- general and administrative expenses, head office expenses, and other expenses that are incurred at the group level and relate to the group as a whole. Costs that are incurred at the entity level on behalf of a segment are segment expenses if they relate to the segment's operating activities and they can be attributed directly or allocated to the segment on a reasonable basis; and
- other items that relate to more than one segment, for which no reasonable basis exists to allocate them to the segments.

IAS 14.16 Because segment income and expense do not include interest income and expense (unless the segment's operations are primarily financial), in our view other components of financial income and expense generally are not included in the segment result even when the related asset or liability is included in segment assets or liabilities.

IAS 14.16, 20 When financial income and expenses are included in the segment result because the segment's operations are primarily of a financial nature, the related assets or liabilities also must be included.

A reconciliation is required between the information disclosed for the reportable segments and the aggregated information in the consolidated financial statements. These items, however, do not constitute additional segments. The reconciling items are likely to include:

- results relating to the corporate function, or assets / liabilities and income / expenditure that cannot be allocated to any reportable segment;
- smaller parts of the business that do not meet the requirements for reportable segments;
- intra-segment balances and transactions that are eliminated on consolidation; and
- other reconciling items that result from different measurement bases used in segment reporting compared to those used in the consolidated financial statements (see 5.2.4).

Some entities use the heading "corporate and other" to indicate the corporate function and other smaller parts of the business that do not meet the requirements for reportable segments. In our view, reconciling items (such as adjustments relating to the elimination of transactions between segments) should not be combined with immaterial and corporate assets / activities. Instead, we believe that unallocated items should be presented separately from consolidation and other adjusting items.

Shared services

Entity F has a group-wide shared service centre that leases out IT equipment and provides the related services to the operating segments of the group. The service centre offers its services outside the group only in very limited instances. Leasing agreements are based on market terms and the

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service centre makes a profit from internal services. Operating segments are not required to acquire services from the service centre and can contract with external third parties.

Because the service centre offers its services to external customers only to a limited extent, it does not earn the majority of its revenue from external customers and therefore is not a reportable segment that must be disclosed. In our view, the service centre is not a part of a vertical operation but is rather a centre that is used by different operating segments. Consequently if all, or substantially all, of the costs incurred by the service centre effectively are incurred on behalf of the other segments and a reasonable basis exists to allocate the assets, liabilities, income and expenses to other reportable segments, these items should be allocated. If allocation is not possible the service centre would be reported as an unallocated item (e.g., corporate centre).

Investments in associates

IAS 14.64-66

The following applies also to interests in joint ventures that are accounted for using the equity method (see 3.5). An entity should assess separately each of its investments in associates. Some may be reported as part of existing reportable segments if the investee has most of its operations in a particular segment, while others may be included in the "other" category. When an entity has an investment in an associate and the associate engages in a business activity that is different from the rest of the group, the entity should consider whether it is necessary to disclose this associate's activities as a separate reportable segment. In our view, we would expect such disclosure to be appropriate only when the associate is reported internally to management as a separate segment and the operations of such an associate are significant in comparison with the total operations of the group.

IAS 14.16

Investments in associates included in segment assets only if the income from associates is included in segment results. In our view, it is preferable to disclose separately the entity's share of the net profit or loss on investments accounted for under the equity method, as well as the aggregate investment in such investments. When these investments are included in reportable segments, they often are presented as line items (e.g., "investments in associates" and "income from associates") separate from other segment assets, revenue or results.

Hedge accounting

Often, in large groups, transactions are hedged at a central level, and hedge accounting is applied only in the group financial statements. In order to claim hedge accounting at a segment level, it must be possible to identify the hedged item at the segment level.

In practice, there are two common approaches to the implementation of hedge accounting by large groups:

- subsidiaries enter into derivative transactions with a central treasury, and are able to apply hedge accounting in their separate financial statements; or
- no internal or external derivatives are entered into by subsidiaries, but a central treasury enters into derivative transactions to hedge transactions entered into by the subsidiaries.

In the second case, the effects of hedging centrally would be allocated to segments only if there is a reasonable basis for doing so. In our view, such a basis is likely to be available when:

- the group treasury enters into internal derivatives with the subsidiaries or operations in the segments and offsets these internal derivatives with one or more external derivatives that qualify for hedge accounting on a group level; and
- appropriate hedge accounting documentation and testing is developed for the group.

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The effects of hedge accounting may be presented using any one of the following approaches, as appropriate:

- when hedge accounting has been applied by individual entities in a group in accordance with the requirements of IAS 39, the segment disclosure will reflect the hedge accounting effects and any internal transactions are eliminated in the reconciliation to consolidated numbers;
- when the hedge accounting requirements of IAS 39 have not been met at a segment level, but the relevant hedge accounting criteria are met at a group level, the hedge accounting effects may be allocated to the segments; and
- hedge accounting effects that cannot be allocated to the segments will be presented as a corporate activity in the same way as other non-allocated items.

Subsidiaries that enter into hedge transactions with a central treasury may qualify to apply hedge accounting in their separate financial statements, in accordance with the requirements of IAS 39. Segment disclosures generally are presented before inter-segment transactions and balances are eliminated (see inter-segment transfers below).

In other cases, documentation and effectiveness testing may be done only at a group level with respect to the external hedges entered into by the group. In our view, allocation of the hedge accounting reflected in the group financial statements to segments may be acceptable even if the internal derivatives would not qualify for hedge accounting in the separate financial statements of the subsidiaries (e.g., due to lack of effectiveness testing at that level) as long as there is a sufficient basis for allocating the gains or losses to the segments. Given the requirements in IAS 39 for identification of hedged items (see 3.6) this should be possible in many cases.

In order to allocate the effects of hedge accounting to a segment, in our view the hedging relationship at the segment level must be identified, either by linking an internal derivative transaction to a hedged item within the segment, or by documenting the allocation of an internal derivative to a hedged item within the segment. In our view, when hedge accounting fails at the group level, for example, because the hedging relationship is ineffective, the hedge accounting effects should not be allocated to a segment.

When hedge accounting cannot be allocated to segments, the hedge accounting effects would be presented in the same way as other non-allocated items.

In our view, groups may find it difficult to find a reasonable basis for allocating the gains and losses from the derivatives used for hedge accounting on a group basis when hedging arrangements are not between individual legal entities. For example, problems may arise when:

- business segments are presented by splitting up legal entities into two or more segments; or
- geographical segments are not aligned with the operating entities that enter into hedging transactions with central treasury.

Inter-segment transfers

IAS 14.24, 75

Amounts reported for each segment are measured on the basis that the entity actually uses to price those transfers. The basis for such pricing must be disclosed by the entity. Segment revenue, segment expense, segment assets and segment liabilities are determined *before* intra-segment balances and intra-segment transactions are eliminated as part of the consolidation process. However, if such intra-group balances and transactions are between group entities within a single segment, they are eliminated in determining the reportable amounts for each segment.

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5.2.4 Segment accounting policies

IAS 14.44, 45

The segment disclosures are an analysis of the amounts presented in the financial statements (i.e., using the same accounting policies). However, the consolidated accounting policies need not be applied to reportable segments as if the segments are separate stand-alone reporting entities.

For example, T has a subsidiary, U, that owns properties that are leased to other group entities as well as properties that are leased to external parties. U is a reportable segment. All properties are accounted for as investment properties in the separate financial statements of U and are measured at fair value consistent with the group accounting policy for investment properties. However, from a group perspective, some of these properties are owner-occupied (those leased to other group entities), and therefore measured at depreciated cost in the consolidated financial statements of T. The segment disclosure for the investment property segment (U) in the consolidated financial statements should include all of U's properties that are leased to external parties at fair value, in line with the group accounting policy for investment properties. In our view, U's properties that are leased to other group entities generally should be measured for segmental reporting purposes at depreciated cost, as this is consistent with the group's policy for owner-occupied properties.

5.2.5 Disclosure

Primary segments

IAS 14.50-67

For each primary reportable segment the following disclosures are required:

- revenue, distinguishing between external customers and inter-segment sales;
- results of operations (broadly, before interest, tax and income from associates);
- depreciation and other non-cash expenses (unless cash flow information is given);
- operating, investing and financing cash flows (as an alternative to the previous item) (see 2.3);
- impairments and reversals of impairment (see 3.9);
- details of discontinuing operations within a segment (see 5.4);
- the share of results and carrying amount of investments accounted for using the equity method for any such investments that can be allocated substantially to a single segment;
- total assets, including goodwill and intangible assets that can be allocated reliably to the segment;
- total liabilities; and
- capital expenditure relating to segment assets, including goodwill and intangible assets.

There are supplementary disclosure requirements if the primary segments are geographical in order that information about both the location of operations and the location of customers is given.

Secondary segments

IAS 14.68-72

The required disclosures for secondary segments will depend upon whether the primary segment reporting is business or geographical and, if geographical, whether based on the location of assets or customers.

IAS 14.69

For the secondary segments, required disclosures include an analysis of the external revenue, total assets and capital expenditure for each segment whose external revenue exceeds 10 per cent of the reporting entity's total external revenue.

Other disclosure

IAS 14.74

Additional disclosure is required for an internally reported segment that has revenue from sales to external customers of 10 per cent or more of the total entity revenue to external customers, but is not identified as reportable because it earns the majority of its revenue from sales to other segments. An entity discloses this fact and the amount of revenue from:

- sales to external customers; and
- internal sales to other segments.

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5.2.6 Changes in identification of segments

IAS 14.76 A change in the identification of segments is a change in accounting policy for segment reporting. Where the activities of the new segment previously were presented as part of another segment, restatement is required, if practicable. If it is not practicable to restate comparative segment information on the new basis, segment information must be presented on both the old and the new basis in the period in which segment identification changes. Additional disclosure is required where identification of segments changes.

However, where the identification of segments changes as a result of the emergence of a new business or activity, which did not exist in the previous periods, there is no change in accounting policy and comparatives are not restated.

5.2.7 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.3 Earnings per share

(IAS 33)

Overview

- **Basic and diluted EPS are presented on the face of the income statement, with equal prominence, for each class of ordinary shares#.**
- **Basic EPS is calculated by dividing the earnings attributable to holders of ordinary equity of the parent by the weighted average number of ordinary shares outstanding during the period.**
- **To calculate diluted EPS, profit or loss attributable to ordinary equity holders, and the weighted number of shares outstanding, are adjusted for the effects of all dilutive potential ordinary shares.**
- **Contingently issuable ordinary shares are included in basic EPS from the date when all necessary conditions are satisfied and, when not yet satisfied, in diluted EPS to the extent that the conditions are met at the reporting date.**
- **When a contract may be settled in either cash or shares it is treated as a potential ordinary share.**
- **For diluted EPS, diluted potential ordinary shares are determined independently for each period presented.**
- **When the number of ordinary shares outstanding changes, without a corresponding change in resources, the weighted average number of ordinary shares outstanding during all periods presented is adjusted.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 33 *Earnings per Share*. The revised standard includes additional disclosure requirements and incorporates the requirements of SIC–24 *Earnings Per Share – Financial Instruments and Other Contracts that May Be Settled in Shares* without change. The revised standard is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, additional guidance and illustrative examples are provided on selected issues including the effects of contingently issuable shares; potential ordinary shares of subsidiaries, joint ventures or associates; participating equity instruments, written put options; purchased put and call options; and mandatory convertible instruments. In terms of disclosure, the revised standard requires that:

- basic and diluted EPS for both continuing and total operations are presented on the face of the income statement, with equal prominence, for each class of ordinary shares; and
- separate EPS data is disclosed for discontinuing operations, either on the face of the income statement or in the notes to the financial statements.

5.3.1 Scope

IAS 33.2, 3 Basic and diluted EPS must be disclosed on the face of the income statement by entities with publicly traded ordinary shares or potential ordinary shares. This information also must be disclosed by entities in the process of issuing ordinary shares or potential ordinary shares that are to be publicly traded. When an entity voluntarily presents EPS data, it should be calculated and presented in accordance with IAS 33.

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"Publicly traded" is not a defined term in IFRSs. In our view, if a buyer or a seller can contact a broker and obtain a quoted price, the shares or potential shares should be regarded as publicly traded. This is without regard to how often the share is traded.

Certain investment funds and other similar entities may have publicly traded ordinary shares, but the price of the shares is determined by reference to the net asset value of the fund rather than a broker or market-based quote. In our view, the funds are publicly traded, and are required to present EPS data.

In our view, EPS data will be required only when the entity has taken active steps to obtain a listing, rather than simply planning the listing. When an entity prepares a prospectus in preparation for listing, EPS data should be included in the prospectus. When an entity's ordinary shares or potential ordinary shares are untraded at the balance sheet date but are publicly traded by the time the financial statements are authorised for issue, in our view the entity should disclose EPS data in its financial statements. This is because the entity generally would have had to provide financial statements to complete the listing and IFRSs would require those financial statements to include EPS data.

An entity's ordinary shares or potential ordinary shares may be publicly traded for only a portion of the current or prior period, for example, because the entity's ordinary shares or potential ordinary shares were listed for the first time during the period. In our view, the entity is required to present EPS data for all periods for which income statements are presented, and not only for the periods that the entity's ordinary or potential ordinary shares were publicly traded.

IAS 33.4

If both separate financial statements and consolidated financial statements are prepared, EPS disclosures are required to be provided only on the basis of consolidated information. However, if an entity decides to provide EPS amounts based on its separate financial statements, it can present this only on the face of its own separate income statement.

Entities with more than one class of equity

IAS 33.6, 33.66

When an entity has more than one class of ordinary shares, EPS should be disclosed for each class of ordinary shares. Ordinary shares of the same class are those shares that have the same right to receive dividends. When an entity has shares with different rights it considers whether the shares are in fact ordinary shares. An ordinary share is defined in IAS 33 as an equity instrument that is subordinate to all other equity shares.

For example, an entity has two classes of ordinary shares – A and B. The holders of class B shares are entitled to dividends equal to 50 per cent of any dividends declared on the class A shares, but otherwise are identical. Therefore, in our view, both class A and B shares are ordinary shares as both classes are subordinate to all other classes of equity instruments with respect to participation in net profit, despite the differences in entitlement to dividends.

In our view, an entity is not required to present EPS data for participating preference shares as they are not considered to be a class of ordinary share. For example, an entity has two classes of shares, X and Y. Shareholders of class X are entitled to a fixed dividend per share as well as the right to participate in any additional dividends declared. The class Y shareholders participate equally with class X shareholders with respect to the additional dividends only. In our view, even if both classes participate equally in residual assets on dissolution, class X shares are not considered to be ordinary, as the fixed entitlement creates a preference over the Y class shares (and the Y class shareholders are subordinate to the X class shareholders). The class Y shares are the only class of ordinary shares, and therefore the only class of shares for which disclosure of EPS is required. However, the participating rights of each class of these shares must be considered in determining earnings attributable to ordinary equity holders (see 5.3.2).

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5.3.2 Basic earnings per share

IAS 33.9, 10 Basic EPS is the profit (or loss) attributable to ordinary shareholders of the parent entity for the period, divided by the weighted average number of ordinary shares outstanding. Presentation of EPS is required for net profit or loss for the period#.

Forthcoming requirements

IAS 33.66 The revised standard requires basic and diluted EPS for both continuing and total operations to be presented on the face of the income statement, with equal prominence, for each class of ordinary shares.

IAS 33.68 Disclosure of separate EPS data is required for discontinuing operations, either on the face of the income statement or in the notes to the financial statements.

Earnings

IAS 33.12-15 Earnings attributable to ordinary shareholders of the parent entity is the net profit or loss, adjusted for the after-tax amounts of dividends on preference shares. In our view, net profit and loss also should be adjusted for gains or losses on the settlement of preference shares, and other similar effects of preference shares classified as equity, including the amortisation of the premium or discount on the original issue of preference shares#.

Forthcoming requirements

IAS 33.33 The revised standard confirms that earnings attributable to ordinary shareholders of the parent entity would be adjusted by after-tax amounts of dividends on preference shares, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

IAS 33.AG14(a) The after-tax amount of preference dividends is deducted to arrive at earnings attributable to ordinary shareholders, as those dividends represent income that is not attributable to ordinary shareholders#. Cumulative preference dividends are deducted, whether declared or not. Non-cumulative dividends are not deducted unless they have been declared at the balance sheet date. In our view, when dividends on non-cumulative preference shares are declared after the balance sheet date, the profit (or loss) attributable to ordinary shareholders should not be adjusted for these dividends even if these dividends relate to the reporting period. This is consistent with the requirement that dividends declared after the balance sheet date are non-adjusting post-balance sheet events (see 2.9).

Forthcoming requirements

IAS 33.17 The revised standard includes more extensive guidance on other adjustments relating to preference shares. Under the revised standard, adjustments to net earnings are made for returns to preference shareholders including differences on settlement of preference shares. Favourable changes to the original conversion terms of convertible preference shares or the payment of additional consideration to the preference shareholders may result in early conversion of the preference shares. The early conversion inducement is included in determining the earnings attributable to ordinary shareholders. If the fair value of the ordinary shares or other consideration paid exceeds the fair value of the ordinary shares issuable under the original conversion terms, this excess is a return to preference shareholders and is deducted in calculating earnings attributable to the ordinary equity holders of the entity. In our view, when the carrying amount of the preference shares exceeds the fair value of the consideration paid to redeem them, this difference is added in the calculation of earnings attributable to the ordinary equity holders.

Participating preference shares

IAS 33.A14 To determine the earnings attributable to ordinary equity holders, profit or loss for the period is allocated to the different classes of ordinary shares and participating equity instruments in accordance with their rights to participate in the undistributed earnings.

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For example, an entity has two classes of shares, X and Y; each class has 100 shares outstanding. Shareholders of class X are entitled to a fixed dividend per share and have the right to participate in any additional dividends declared. The class Y shareholders participate equally with class X shareholders with respect to the additional dividends only. Net profit for the period is 2,000 and preference dividends of 100 are paid to the X shareholders. Even though the entity has no intention to pay additional dividends, to calculate earnings attributable to the Y shares, the earnings of 1,900 must be allocated to both the X and Y shares in accordance with their participation.

Assuming that there are no other potential ordinary shares and the preference shares are not convertible, earnings attributable to ordinary shareholders are determined as follows:

Profit for the period attributable to equity holders of the parent	2,000	
Preference dividends paid	100	
Undistributed earnings	1,900	
Earnings attributable to ordinary shareholders of the parent	950	(1,900/2)
Earnings attributable to participating preference shareholders	1,050	(1,900/2 + 100)

Weighted average number of shares outstanding

Treasury shares

IAS 33.IE example 2

Treasury shares are not treated as outstanding ordinary shares. Assets held by employee benefit plans or equity compensation plans may include an entity's own shares (see 4.4 and 4.5). The requirement for consolidation of SPEs does not apply to post-employment benefit plans or equity compensation plans (see 2.5). Therefore, own shares that are qualifying plan assets held by an employee benefit plan and netted against the employee benefit obligation are not treasury shares, and in our view would be considered outstanding for the calculation of EPS. However, if shares do not meet the definition of plan assets, they are presented as treasury shares, even though the plan is not consolidated by the employer (see 4.4), and therefore, in our view, would not be considered as outstanding for the purposes of calculating EPS.

Forthcoming requirements

IAS 32.4(f), 33, 34

The revised standard clarifies that own shares held in connection with an equity compensation plan are within the scope of IAS 32. Accordingly, these shares would not be treated as outstanding ordinary shares for the purposes of calculating EPS.

Contingently issuable shares

IAS 33.24

Contingently issuable shares are ordinary shares that are issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement. Contingently issuable shares should be included in the calculation of the weighted average number of shares outstanding from the date that the conditions are met.

In our view, shares that are issuable solely after the passage of time are not considered contingently issuable as the passage of time is a certainty#. Therefore, these shares are included in the calculation of the weighted average number of shares from the date that the contract is entered into.

Forthcoming requirements

IAS 33.24

The revised standard requires shares issuable solely after the passage of time to be treated as outstanding and not contingently issuable.

Partly paid shares

IAS 33.A15

When ordinary shares are not fully paid, they are treated as a fraction of ordinary shares for the purposes of basic EPS. The fraction is calculated as the degree to which they are entitled to participate in dividends during the period relative to a fully paid ordinary share.

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Ordinary shares subject to recall

IAS 33.19 (1998)
When ordinary shares are subject to recall, they are treated as contingently issuable shares, as described above#.

Forthcoming requirements

IAS 33.25
Under the revised standard, when ordinary shares are subject to recall, they are not considered as outstanding and are excluded from the calculation of basic EPS until the date when they are no longer subject to recall.

5.3.3 Diluted earnings per share

IAS 33.30, 31
To calculate diluted EPS, an entity adjusts profit or loss attributable to ordinary equity holders of the parent entity (numerator), and the weighted average number of shares outstanding (denominator), for the effects of all dilutive potential ordinary shares. Potential ordinary shares are contracts that may entitle its holder to ordinary shares. Examples include:

- convertible debt or preference shares;
- share warrants or options; and
- shares that would be issued upon satisfaction of certain conditions resulting from contractual arrangements, such as the purchase of a business.

IAS 33.38 (1998)
Potential ordinary shares that have lapsed or have been converted during the period are reflected in the diluted EPS calculation (if they are dilutive) from the first day of the period to the day they lapsed or were converted. Potential ordinary shares issued during the period are included in the diluted EPS calculation (if they are dilutive) from the day that they are issued#.

IAS 33.41
The effects of potential ordinary shares are reflected in diluted EPS when their inclusion in the calculation would decrease EPS, or increase the loss per share (i.e., would be dilutive), from *continuing operations* before extraordinary items#.

When considering whether potential ordinary shares are dilutive or anti-dilutive, each type of potential ordinary share is considered separately rather than in aggregate. The goal in computing diluted EPS is to calculate the maximum dilution effect, and therefore each type of potential ordinary share should be considered in sequence from the most dilutive to the least dilutive. To determine the sequence it is necessary to calculate the effect that the conversion of the potential ordinary shares would have on both earnings from continuing operations and the number of shares#.

Forthcoming requirements

IAS 33.41
The revision to IAS 1 to eliminate the presentation of items as extraordinary resulted in a change to the "control" number for testing dilution. The new "control" number is EPS from continuing operations.

IAS 33.37
The revised standard confirms that diluted potential ordinary shares be determined independently for each period presented. Additionally, it comments that the number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim computation.

Adjustments to basic EPS

Earnings

IAS 33.33-35
To calculate diluted earnings, the numerator used for the calculation of basic EPS is adjusted for the after-tax effect of any dividends, interest and income or expense items related to the dilutive potential ordinary shares. Examples of expenses that may result from the conversion of potential ordinary shares include transaction costs incurred on a conversion. Conversion of convertible debt may result in lower interest expense and therefore higher net profit and, ultimately, increased employee profit-sharing expense. All these impacts are included in the adjustment to the numerator.

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Weighted average number of shares

The denominator (the weighted average number of ordinary shares) used for the calculation of basic EPS is adjusted for the weighted average number of ordinary shares that would have been issued on conversion or issuance of the dilutive potential ordinary shares.

Options, warrants and other potential ordinary shares

Typical potential ordinary shares are options, warrants, convertible debt securities and convertible preference shares.

IAS 33.45

To calculate diluted EPS, the entity assumes that dilutive options and warrants are exercised. For options and similar instruments, dilution is computed using the treasury share method, with only the bonus element of the issue reflected in diluted EPS. The treasury stock method assumes that the proceeds (strike price) from exercising the option are used to buy back shares at the average market price of a share during the period. The bonus element is the difference between the number of ordinary shares that would be issued at the strike price and the number of ordinary shares that would have been bought back at the average market price.

Options, warrants and other potential ordinary shares issued subject to conditions, for example service conditions on employee share options, are contingently issuable potential ordinary shares. See *Vesting conditions* and *Contingently issuable shares* below.

The average market price of an ordinary share is required to determine the bonus element when the treasury stock method is used to calculate diluted EPS. In some cases, there may not be a quoted market price for the ordinary shares for the full period, for example, because the entity does not have ordinary shares or potential ordinary shares that are publicly traded (and the entity elects to disclose EPS), or the entity's ordinary shares or potential ordinary shares were not listed for the full period (having been listed during the period). For example, an entity with a 31 December annual reporting date lists its ordinary shares on 7 November, so that it only has a quoted market price for its shares during the period from 7 November to 31 December. The entity has ordinary shares outstanding during the current and comparative periods.

IAS 39.AG74-79

In our view, if the average market price of the shares is necessary to calculate diluted EPS (e.g., because the entity has outstanding warrants or options), the average market price used should be a meaningful average for the full reporting period or the period that the potential ordinary shares are outstanding. We do not believe that an average market price for two months, as in the example above, would be meaningful for potential ordinary shares outstanding for the full year. We believe that it is preferable to use another method to obtain a reliable average over the reporting period. In our view, when there is no active market for a financial instrument, an entity should determine fair value using valuation techniques. An entity should apply the guidance in IAS 39 to determine the fair value of unquoted equity instruments (see 3.6) in order to estimate the average market price for the ordinary shares.

Specialist expertise may be required in this assessment, and, in our view, the method used to determine the average market value should be disclosed in the notes to the financial statements.

Options that require an entity to issue shares also may be present in agreements other than straight forward written options. For example, entity A and entity B enter into an agreement whereby each entity contributes a certain portion of their businesses to a newly formed entity ("Newco"). Entity A holds 45 per cent of Newco and Entity B holds 55 per cent. The ordinary shares of B are quoted. B grants a put option to A, whereby A can put its 45 per cent interest in Newco to B for 500 million in value of B's ordinary shares.

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This put option would be considered in B's calculation of diluted EPS. To determine if it would be dilutive, B would need to prepare an analysis of the fair value of Newco, as A's 45 per cent share of Newco would be the proceeds that B would receive from the issuance of 500 million of value of its ordinary shares. If the value of the 45 per cent share is less than 500 million, the put option is dilutive. If not, it is anti-dilutive, and would not be reflected in the diluted EPS calculation, but B would be required to disclose information about the existence and the effects of the anti-dilutive put option.

Forthcoming requirements

IAS 33.62, 63 The revised standard added guidance on the impact of written and purchased options on own shares for calculating EPS. When an entity has purchased options on its own shares, these are excluded from diluted EPS because IAS 33 presumes these options would be exercised only when they are "in-the-money" and therefore anti-dilutive. Written put options and forward purchase contracts are included in diluted EPS if dilutive (i.e., if they are "in-the-money").

Partly paid shares#

Forthcoming requirements

The revised standard provides additional guidance regarding how the unpaid balance of partially paid shares is treated in the calculation of diluted EPS.

IAS 33.A16 The unpaid balance of any partly paid shares, which are treated as options or warrants, is regarded as the proceeds from issuing shares. These proceeds are assumed to be used to purchase ordinary shares at the average market price for the period. The number of shares included in diluted EPS is the difference between the number of unpaid shares not included in basic EPS and the number of shares assumed to be purchased with the remaining purchase consideration.

Vesting conditions

IAS 33.48 In our view, employee share options with fixed or determinable terms and unvested ordinary shares are treated as outstanding in the calculation of diluted EPS, even though they may be subject to vesting. They are treated as outstanding potential ordinary shares from the grant date. Performance-based employee share options and shares are treated as contingently issuable options and shares because their issue is contingent upon satisfaction of specified conditions in addition to the passage of time. In our view, shares that are issuable solely after the passage of time are not contingently issuable shares (see 5.3.2)#.

Forthcoming requirements

The revised version of IAS 33 confirmed that options granted subject to vesting should be treated as outstanding in the calculation of diluted EPS. Revised IAS 33 also confirmed the treatment described above regarding shares issuable contingent solely on the passage of time.

In February 2004, the IASB issued IFRS 2 *Share-based Payment*. Limited amendments have been made to IAS 33 as consequential amendments from IFRS 2, including an additional example on the calculation of diluted EPS when IFRS 2 is applied (see 4.5A).

In calculating diluted EPS, an entity adjusts the exercise price of potential ordinary shares to include the fair value of goods or services that will be recognised as an expense in future periods.

Contracts that may be settled in ordinary shares or cash

IAS 33.58, 60 When a contract can be settled in either cash or shares it is a potential ordinary share, even if the issuer controls the form of settlement. When an entity issues a contract that may be settled in ordinary shares or cash at the *entity's* option, the entity should presume that the contract will be settled in ordinary shares#.

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Forthcoming requirements

IAS 33.60

The revised standard requires that for contracts that may be settled in ordinary shares or cash at the *holder's* option, the entity should use the more dilutive of cash settlement and share settlement in calculating diluted EPS. In the previous example, if an exercise of the put option by A, B had a choice to settle either in cash or by issuing shares, B would presume that it will settle the contract by issuing shares and then determine whether the impact is dilutive, as above. However, if the election to receive cash or shares was at A's option, B should evaluate which is the more dilutive of cash or equity settlement and assume that option is used in the calculation of diluted EPS.

Contingently issuable shares

IAS 33.52

When ordinary shares are issued and are not subject to conditions, these ordinary shares are included in basic EPS. In other cases, when the issuance of shares is subject to conditions (other than solely the passage of time, see 5.3.2), these shares are considered to be contingently issuable shares. Contingently issuable shares are included in diluted EPS (if dilutive), based on the assumption that the balance sheet date is the end of the contingency period#.

An example of contingently issuable ordinary shares is when a loan agreement allows the lender to convert the loan into ordinary shares of the borrowing entity under certain conditions, for example, on default by the borrower or a credit rating downgrade of the borrower (triggering events).

IAS 33.IE example 7

The loan clause gives rise to contingently issuable potential ordinary shares. If the borrower defaults during the period, the conversion option would be exercisable. The number of shares to be included in the diluted EPS computation should be based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. If a triggering event has occurred, the ordinary shares would be considered in the calculation of diluted EPS from the date of the triggering event (or as of the date of the loan agreement, if later), and not from the beginning of the period.

IAS 33.24

If the option has been exercised, the contingently issuable shares would be outstanding and would be included in the calculation of basic EPS from the exercise date, even if the shares had not yet been issued. This is because there are no further conditions or payments required and the issue of shares is contingent on the passage of time.

Contingencies related to earnings targets#

Forthcoming requirements

IAS 33.53, 54

The revised standard provides additional guidance on calculating EPS when the entity has issued shares that are contingent on attaining or maintaining a specified amount of earnings.

If the issue of shares is contingent on attainment or maintenance of a specified amount of earnings, and the entity attains the specified amount of earnings but also is required to maintain the level of earnings for an additional period, then shares should be considered as outstanding only for diluted EPS. The diluted EPS should be based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period. These contingent shares are not considered outstanding for basic EPS, unless the earnings have been maintained for the required period.

For example, an entity hires a consultant to evaluate the entity's operating costs and recommend ways for the entity to reduce its operating costs. If the operating costs are reduced by 350 million over a year, and this cost reduction is sustained for a further year, then the consultant will receive two and a half per cent of the entity's issued ordinary shares. If costs are reduced by 700 million over a year, and this cost reduction is sustained for a further year, then the consultant will receive five per cent of the entity's issued equity. The consultant has three years to achieve these targets.

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After one year, the consultant achieves only 200 million of cost savings. If this were the end of the contingency period, no shares would be issued, and therefore there is no impact on either basic or diluted EPS. At the end of the second year, cost savings of 400 million have been achieved, but not yet sustained. There is no impact on basic earnings per share, as the cost savings have not been sustained, but the potential ordinary shares (two and a half per cent of the entity's issued ordinary shares) will be included in the calculation of diluted EPS. Once the cost savings have been sustained for a year, the effect of the shares to be issued also will be included in the calculation of basic EPS.

Contingencies related to price levels

Forthcoming requirements

IAS 33.54 The revised standard also provides additional guidance on calculating EPS when the number of ordinary shares that are contingently issuable depends on the future market price of the ordinary shares and the effect is dilutive. In this case, the calculation of diluted EPS should be based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

For example, an entity issues a contingently convertible bond, with a conversion price of 130. Conversion may take place only if the share price exceeds 143. In our view, if this condition is met at the balance sheet date, the contingently issuable shares will be considered in calculating diluted EPS, but not in basic EPS as the conversion option has not been exercised. However, where the share price exceeded 143 part way through the year but has fallen below this level at the reporting date, the potential ordinary share will not be included in either basic or diluted EPS at the balance sheet date.

IAS 33.37 During any interim reporting period, the entity would have to consider whether the conditions were met at that interim reporting date and whether the contingently issuable shares are dilutive for the calculation of diluted EPS. In our view, this would be necessary even if the share price had declined below the trigger level after the balance sheet date but before the interim financial statements were authorised for issue.

5.3.4 Restatement

IAS 33.26, 64 The current and prior period figures for basic and diluted EPS should be adjusted for transactions, other than the conversion of potential ordinary shares, that adjust the number of shares without a corresponding change in resources. A change in the number of shares without a corresponding change in resources occurs, for example, with a bonus share issue, share consolidation or split, or if there is a bonus element in a rights issue. Basic and diluted EPS also are adjusted for a bonus issue, share split or reverse share split that occurs after the balance sheet date but before the financial statements are authorised for issue. The number of ordinary shares is adjusted as if the event had occurred at the beginning of the earliest period presented.

As an example, an entity has 700 shares outstanding during the year to 31 December 2003. On 1 January 2004, it issues 300 shares for cash. Subsequent to the share issue, the entity issues bonus shares to its equity holders, who receive one share for every share held immediately before the bonus issue. EPS and diluted EPS data are not restated for the impact of the issue of 300 shares for cash, but restatement of the 31 December 2003 EPS data is required for the subsequent bonus issue of shares, as no additional resources were received by the entity in this regard. 1,400 (700 x 2) shares would be used in the calculation in 2003 and 2,000 (1,000 x 2) shares used in year 2004.

Conversion of potential ordinary shares does not result in a retrospective adjustment to EPS. For example, an entity issues share warrants to its shareholders for no consideration. The exercise price of the warrants is 10, which is equal to the market price of the shares on the date of issue. The warrants are exercised a number of years later when the market price of the shares is 15.

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In our view, the determination of whether a bonus element exists is made once, at the time that the warrants are issued. At that time, the exercise price was equal to the market price of the shares and therefore there was no bonus element. Therefore, during periods when the market price exceeded the warrant strike price, the warrants would have been included in the determination of diluted EPS. In the basic EPS calculation, the issuance of the ordinary shares on exercise of the warrants will affect only the weighted average number of ordinary shares outstanding during the period, without any further adjustment.

Diluted EPS are not restated for any subsequent changes in assumptions made in calculating the effects of conversion of potential ordinary shares, such as the average market price or whether contingently issuable shares will be issued.

IAS 33.64, 70 Ordinary share or potential ordinary share transactions (other than those that adjust the number of shares outstanding without a corresponding change in resources) that occur after the balance sheet date are not accounted for retrospectively, but are disclosed in the financial statements.

5.3.5 Presentation and disclosure

IAS 33.67 EPS figures are presented for all periods presented, including interim periods.

IAS 33.66-70 Basic and diluted EPS should be presented on the face of the income statement. Basic and diluted EPS are to be presented with equal prominence for all periods presented#. An entity must provide a reconciliation of the earnings used in the EPS and diluted EPS calculations to profit or loss attributable to the parent entity.

Forthcoming requirements

IAS 33.66 The revised standard requires basic and diluted EPS for both continuing and total operations to be presented on the face of the income statement, with equal prominence, for each class of ordinary shares.

Under the revised standard disclosure of separate EPS data is required for discontinued operations, if presented, either on the face of the income statement or in the notes to the financial statements.

IAS 33.67 In some cases, there may be no difference between basic and diluted EPS. This will occur, for example, when there are no potential ordinary shares, or the only potential ordinary shares are anti-dilutive and therefore excluded from the calculation of diluted EPS. In such cases, the entity still is required to disclose both basic and diluted EPS. However, this could be achieved by presenting only one line in the income statement, labelled "basic and diluted EPS". In our view, when basic and diluted EPS are equal, the entity would not be required to disclose a reconciliation of the weighted average number of ordinary shares used in the EPS calculation to the diluted EPS calculation (which otherwise would be required). However, if diluted EPS is reported for at least one period, it should be reported for all periods presented, even if it equals basic EPS.

IAS 33.73 EPS based on alternative measures of earnings also may be given if considered necessary. In our view, such amounts should be presented in the notes to the financial statements only and not on the face of the income statement.

Entities may wish to present additional measures of EPS, for example, an entity may disclose EBITDA per share (see 4.1 on the presentation of EBITDA). In these cases, both basic and diluted amounts per share should be disclosed in the notes to the financial statements for the alternative performance measure and each disclosed with equal prominence. The entity should describe the basis for determining the earnings amount, which should be consistent over time, and the earnings used must be reconciled to a line item that is reported on the face of the income statement.

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5.3.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.4 Discontinuing operations

(IAS 1, IAS 35)

Overview

- **A discontinuing operation is defined only for classification and disclosure purposes.**
- **A discontinuing operation is a component of an entity that, pursuant to a single plan, is being disposed of or abandoned.**
- **The component must represent all or substantially all of a separate major line of business or geographical area of operation that can be distinguished operationally and for financial reporting purposes.**
- **An operation is discontinuing when, before the financial statements are authorised for issue, either there is a binding sale agreement for its disposal or there is an announced plan for its discontinuance.**
- **Comparative periods are restated for operations that are classified as discontinuing either during the reporting period or after the reporting period but before the financial statements are authorised for issue.**
- **The *net* operating results of a discontinuing operation may not be presented as a single figure in the income statement.**
- **The *net* assets and *net* liabilities of a discontinuing operation may not be presented as two single figures in the balance sheet.**
- **The carrying amounts of the total assets and liabilities, as well as the amounts of revenue, expenses, pre-tax profit, attributable taxes, and operating, investing and financing cash flows of the discontinuing operation are disclosed either in the notes or on the face of the financial statements.**

Forthcoming requirements

In March 2004, the IASB issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 replaces IAS 35 *Discontinuing Operations*. This new standard is applicable prospectively from 1 January 2005 and earlier application is encouraged, subject to certain restrictions. It is probable that significant changes will result from its adoption. The requirements of IFRS 5 are discussed in 5.4A.

Under IAS 35 a discontinuing operation is identified for presentation and disclosure only. Recognition and measurement of assets and liabilities of a discontinuing operation is in accordance with other IFRSs.

5.4.1 Definition

IAS 35.2 A discontinuing operation is a component of an entity that, pursuant to a single plan, is being disposed of or abandoned. The component must represent all or substantially all of a separate major line of business or geographical area of operation that can be distinguished operationally and for financial reporting purposes.

In our view, the starting point for the determination of whether a component qualifies for presentation as a discontinuing operation is how the entity identifies and discloses reportable segments (see 5.2).

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Pursuant to a single plan

An entity must have a single overall plan under which all or substantially all of a component of its operations is discontinued. Under the plan, the component may be disposed of in its entirety or by selling the assets and liabilities on a piecemeal basis.

For example, during June 2003, D agrees to dispose of some of its manufacturing facilities within the kitchen segment. In the following years, other facilities within the segment may be disposed of and the remaining operations combined with another business within D. In our view, D's kitchen segment is not a discontinuing operation. While different parts of the kitchen segment will be disposed of on a piecemeal basis, in this case there is no single plan to dispose of the segment.

In our view, a qualifying plan may result when an entity changes its initial plan. For example, Y is a retailer that identifies primary segments based on products and services, one of which is office products. Y has two operations within this segment, one in Spain and one in Portugal. These are considered to be part of a single geographic segment for secondary segment reporting purposes. During its reporting period ending 31 December 2003, Y publicly announces that it will close the Spanish store in order to reduce costs and to enhance operating efficiencies. Y intends to continue operating the store in Portugal. Subsequent to the end of the reporting period, but prior to the approval of the financial statements, Y enters into a binding sale agreement to sell the store in Portugal.

The closure of the store in Spain alone is unlikely to meet the definition of a discontinuing operation because Y plans to continue similar operations in Portugal. The subsequent disposal of the store in Portugal represents a change to the initial plan. By its actions, before the issue of the financial statements, Y has revised the original plan. In our view, a re-evaluation of the plan shows that Y is demonstrably committed to a complete exit from a major line of business. Therefore, we believe that the planned closure of the Spanish store together with the sale of the Portuguese store subsequent to the end of its reporting period, but before the authorisation of the financial statements for issue, is a plan to discontinue the office products component of Y's business. Therefore, office products should be presented as a discontinuing operation at 31 December 2003.

Component that is a separate major line of business

IAS 35.9 A reportable business segment or geographical segment (see 5.2) normally would represent a separate major line of business or geographical area of operation.

For example, E has five different reportable business segments, one of which produces cigars. All of the cigar growing and production facilities are situated in Central America. E also has other operations in Central America for other business segments and E's Central American operations are considered a separate secondary (geographical) segment. In October 2003, E announces a plan to dispose of the cigar segment. In our view, the cigar segment meets the definition of a component of a business and would qualify for reporting as a discontinuing operation. It is not necessary that the component also is a geographic segment. There is a single plan to dispose of an operation that comprises a separate segment, which can be distinguished operationally and for financial reporting purposes.

Part of a segment also may satisfy the definition of a discontinuing operation to the extent that this part of a segment represents a major line of business or geographical area.

Discontinuance of products

Abandoning or discontinuing products in a product line or replacing them with newer products is a part of the normal evolution of a business and does not constitute a discontinuing operation. For example, A has four segments, ice cream, chocolate, beverages and snack foods. Management decides to discontinue producing some of the chocolate bars containing nuts and instead will add chocolate bars containing fruit to its product range.

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In our view, the decision to discontinue producing chocolate bars with nuts does not constitute a discontinuing operation. Even though there may be a single plan to cease production of nut chocolate bars, the nut chocolate bars do not represent a major product line.

In our view, the sale of a brand also will not meet the definition of a discontinuing operation, unless it represents a separate line of business of the entity.

Closure of a facility

Closure of facilities due to productivity or other cost reasons often is a part of the general development within a business and does not necessarily meet the definition of a discontinuing operation. For example, C decides to close one of its seven facilities in North America as it is cheaper to manufacture its products in South East Asia. The facilities are included in the clothing segment together with other facilities in North America, South East Asia and Eastern Europe. Management has formalised the plan and informed its employees about the decision.

In our view, even if the closure of the facility is subject to a single plan, this transaction does not meet the definition of a discontinuing operation as the same component of the business will continue operating using some different facilities. However, the closure may require recognition of impairment charges and provisions triggered by the restructuring (see 3.9 and 3.11).

Disposal of a subsidiary

IAS 35.8(e) In our view, evaluation of whether an operation is a separate major line of business is based on the nature and organisation of the entity's operations, and does not require alignment with legal entities within the organisation. Therefore, a decision to sell or dispose of a subsidiary is not automatically a discontinuing operation if that subsidiary is not, on its own, a separate major line of business.

For example, B sells baby clothes, sport clothes, toys and gardening equipment and reports each product group as a separate segment. In September 2003, B announces its plan to dispose of Boom, a significant subsidiary included in the toy segment. B retains other operations in the toy segment.

In our view, even though the disposal of Boom may be significant for B, is subject to a single plan, and can be distinguished operationally and for financial reporting purposes, the disposal of Boom should not be classified as a discontinuing operation. This is because there are other operations within the same segment producing toys and therefore Boom on its own does not represent a separate major line of business or geographical area of B.

IAS 1.86 However, as the disposal of Boom is significant, the impact of the disposal may require separate disclosure (see 4.8).

Venture capital investors

Venture capital investors often acquire interests in a variety of businesses. Investments may be held for three to five years and then sold. Venture capital investors are required to consolidate entities that they control (see 2.5). Typically, when a new investment is proposed, a key feature of the proposal is the exit strategy. The disposal phase of an investment may be carried out in such a way that it may meet the definition of a discontinuing operation.

In our view, if the investments to be sold in a particular year are a significant component or segment of the entity's operations, the disposal is pursuant to a single plan, and the investment can be distinguished operationally and for financial reporting purposes, then the entity should present the disposal as a discontinuing operation.

However, in our view, the component is unlikely to be a discontinuing operation from the date of its acquisition, as the planned disposal is only an intention at that date. It is unlikely that there would be

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either a binding sale agreement or announced plan for discontinuance that is sufficiently specific to qualify for presentation as a discontinuing operation from the date of its acquisition.

5.4.2 Initial disclosure event

IAS 35.16 An operation is presented as a discontinuing operation after the earlier of:

- a binding sale agreement (for all or substantially all of the whole of the operation); or
- an announced plan for the discontinuance.

IAS 35.29 Once the initial disclosure event occurs, the operation is classified as discontinuing in all financial statements (including comparatives) *issued* thereafter. Therefore, when the initial disclosure event occurs between the balance sheet date and the authorisation of the financial statements for issue, the financial statements, including comparatives, reflect the operation as discontinuing.

Public announcement

An operation is not considered to be discontinuing when an entity has only an intention to discontinue the activities which it has not communicated publicly, even if this intention is reflected in the entity's business plan. For example, T acquires a group of entities and its business plan is to dispose of a number of the entities over the following two years. At acquisition, no commitments or agreements have been entered into or announced regarding any of the acquired subsidiaries for which disposal is planned.

In our view, these intended disposals do not satisfy the conditions to be presented as discontinuing operations because there is no public announcement or binding sale agreement. The arrangement may meet the definition of a restructuring on acquisition (see 2.6 and 3.11)#.

Forthcoming requirements

IFRS 3 IFRS 3, which replaces IAS 22, modifies the conditions when a provision is recognised as part of a business combination (see 2.6).

In our view, the announcement of a disposal plan must occur before financial statements may be presented showing these operations as discontinuing. Reference to, or announcement of, planned disposals in an entity's financial statements is not enough for those financial statements to reflect the decision to discontinue. The public announcement in the financial statements occurs after the date of authorisation of the financial statements.

Binding sale agreement

IAS 35.4 The date that a binding sale agreement is entered into often will differ from the date when payments are made or when control of the discontinuing operation is transferred. In some cases, a binding sale agreement may contain conditions. These conditions may be procedural (or routine), for example, to allow funding arrangements to be finalised; or they could be substantial, for example, clearance by competition authorities. Often the transfer of control only takes place after these conditions have been satisfied, but the initial disclosure event occurs at the time the binding sale agreement is concluded.

5.4.3 Recognition and measurement

IAS 35.17 IAS 35 is a disclosure and presentation standard and does not contain any special recognition and measurement requirements for assets and liabilities that are part of a discontinuing operation. Instead, the requirements of other standards continue to apply. Recognition and measurement requirements that are likely to be relevant include impairment (see 3.9), restructuring provisions (see 3.11) and termination benefits (see 4.4).

An entity continues to recognise ongoing operating profits and losses from discontinuing operations as they are incurred. The general prohibition on accrual of future operating losses also continues to apply (see 3.11).

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When a discontinuing operation is disposed of, any profit or loss on the sale is recognised in the period that the sale is recognised. However, an expected loss on sale may indicate that assets to be sold may be impaired at the reporting date.

For example, an operation is identified as discontinuing and is sold subsequent to C's reporting date (31 December) but prior to the approval of the financial statements by the directors. The loss on the sale includes a goodwill write-off of 100,000. In our view, the loss is recognised at 31 December only if the goodwill is considered to be impaired at that date (see 3.9). If at the reporting date goodwill would have been recoverable through operations, then its impairment is considered to be a non-adjusting post-balance sheet event, triggered by the entity's decision to sell the operation. If, however, goodwill was not recoverable through operations at 31 December, then it is likely that it is at least partially impaired at that date.

IAS 37.51, 37.83 Any gain on disposal of the assets of a discontinuing operation may not be anticipated and offset against provisions or other liabilities recognised in respect of the discontinuing operation. For example, the future gain on disposal of net assets may not be offset against the provision required for the costs of terminating employees.

5.4.4 Presentation

IAS 35.38 Information on discontinuing operations should be given separately for *each* discontinuing operation.

IAS 35.27 The following financial statement disclosures are required in respect of each discontinuing operation:

- The income statement disclosures required are revenues, expenses, pre-tax profits or losses and any attributable tax.
- The cash flow statement disclosures required are the net cash flows from operating, investing and financing activities attributable to the discontinuing operation.
- The balance sheet disclosures required are the carrying amount of the total assets and total liabilities.

This information may be given in the notes, although a preference is expressed for the income statement and cash flow information to be on the face of those statements.

IAS 35.39 The gain or loss on disposal of a discontinuing operation is required to be presented as a separate line item on the face of the income statement. There is no guidance on whether the line item should be included in operating profit or not. In our view, the gain or loss normally should be included in operating profit.

IAS 1.81 When an entity provides disclosures on the face of the income statement and cash flow statement, in our view, it is preferable to present sub-totals for each income statement line item still on the face of the income statement, for example, total revenue. In our view, an entity should not present the income statement split into vertical columns (for continuing and discontinuing operations) without including a total column.

IAS 1.68 The assets and liabilities relating to a discontinuing operation cannot be presented separately on the face of the balance sheet unless the balance sheet is presented in columnar format showing continuing operations, discontinuing operations and entity totals. The assets and liabilities of the discontinuing operation still must be classified as part of the respective balance sheet line items.

In our view, when a disposal or abandonment does not meet the definition of a discontinuing operation, an entity still may present additional information about the disposal (i.e., similar information to that required by IAS 35), but the term discontinuing operation cannot be used. Such transactions often will meet the definition of a restructuring and disclosure about provisions and contingent liabilities also may be required (see 3.11).

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5.4A Non-current assets held for sale and discontinued operations (IFRS 5)

Overview

- **The standard is effective from 1 January 2005, with early application encouraged, subject to certain limitations.**
- **Non-current assets (and some groups of assets and liabilities known as disposal groups) are classified as held for sale when their carrying amounts will be recovered principally through sale. Comparatives are not restated when an asset or disposal group is classified as held for sale.**
- **Non-current assets (and disposal groups) held for sale generally are measured at the lower of carrying amount and fair value less costs to sell and are disclosed separately on the face of the balance sheet.**
- **Assets classified as held for sale are not amortised or depreciated.**
- **An operation is discontinued when it is disposed of or is classified as held for sale, whichever is earlier. Comparative income statement and cash flow information is represented based on the classification of operations (as continuing or discontinued) at the current reporting date.**
- **Generally, the separate presentation of discontinued operations is limited to those operations that are a separate major line of business or geographical area and controlled entities acquired exclusively with a view to resale.**
- **Discontinued operations are presented separately on the face of the income statement.**

In March 2004, the IASB issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. The standard is effective for annual accounting periods beginning on or after 1 January 2005 and replaces IAS 35 *Discontinuing Operations* (see 5.4). The transitional requirements are described below (see 5.4A.5).

5.4A.1 General

Classification as held for sale changes the measurement basis of most non-current assets and of disposal groups. Classification as held for sale also determines the balance sheet presentation of such non-current assets and disposal groups.

Classification as a discontinued operation determines only the presentation of the operation in the income statement and notes to the financial statements. There are no recognition or measurement impacts from classifying an operation as discontinued. However, a discontinued operation will include non-current assets or a disposal group or groups.

IFRS 5.A A *disposal group* is a group of assets to be disposed of together, by sale or otherwise, in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

5.4A.2 Held for sale

IFRS 5.2 The *classification* and *presentation* requirements apply to all non-current assets and to disposal groups.

IFRS 5.2, 5 The *measurement* requirements do not apply to certain assets. These assets are excluded either because measurement would be difficult (e.g., deferred tax assets) or because the assets generally are carried on the basis of fair value with changes in fair value recognised in the income statement

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(e.g., financial assets classified as trading (see 3.6) and investment properties measured at fair value (see 3.4)).

IFRS 5.4 18, 19, 23 Excluded assets are *measured* using the standards that normally apply to these items, even if such assets are part of a disposal group. However, the disposal group as a whole is measured in a manner consistent with non-current assets that are held for sale.

As a result, non-current assets such as some financial assets may be classified and presented as held for sale but measured in accordance with other standards.

In the case of a disposal group, while the group as a whole is measured at the lower of carrying amount and fair value less costs to sell (see below), individual assets and liabilities will not be.

Classification

IFRS 5.6 A non-current asset or disposal group is reclassified as held for sale when its carrying amount will be recovered principally through a sale transaction.

IFRS 5.7 This is the case when the asset is *available for immediate sale* in its present condition and its sale is *highly probable*, in other words significantly more likely than merely probable.

IFRS 5.IG1 A need to obtain or construct a replacement asset (e.g., a new headquarters) or to cease operations that will not be transferred with the asset means that the asset is not available for immediate sale.

In our view, a reduction in the level of ownership of a subsidiary that does not result in a loss of control is insufficient for the consolidated assets and liabilities to be considered to be recovered principally through a sale transaction.

IFRS 5.8 To be highly probable, there must be commitment to a plan to sell and that plan must have been initiated. This requires active marketing at a price that is reasonable in relation to its fair value. There must be an expectation that the sale will be completed within one year of the classification of assets or a disposal group as held for sale, subject to extension in certain circumstances.

IFRS 5.IG7 In our view, when an active market exists, active marketing at a reasonable price generally will lead quickly to a sale. Accordingly, it is unlikely that a non-current asset with a quoted market price will be classified as held for sale for any significant period of time before disposal.

IFRS 5.10 Exchanges of non-current assets are a sale for the purposes of classification of an asset (or disposal group) as held for sale, provided that the expected exchange has commercial substance (see 3.2).

IFRS 5.13 Assets that are to be abandoned or mothballed are not classified as held for sale as they will not be recovered principally through a sale transaction.

IFRS 5.12 Classification as held for sale is *prohibited* when the criteria are met only *after* the balance sheet date. Instead, disclosures are required in the notes to the financial statements.

IFRS 5.40 Comparatives are not restated to reflect the classification at the current reporting date.

Measurement including recognition of gains and losses

Before reclassification as held for sale

IFRS 5.18 Before classification as held for sale, non-current assets (and the assets and liabilities in a disposal group) should be remeasured in accordance with applicable IFRSs. For example, property, plant and equipment must be tested for impairment. In our view, any resulting gains or losses are recognised in accordance with the relevant standards.

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On initial classification as held for sale

IFRS 5.15 On *initial classification* as held for sale, disposal groups and non-current assets are measured at the lower of their:

- carrying amount; and
- fair value less costs to sell.

IFRS 5.20, 5.IG10 Impairment losses on *initial classification* of a non-current asset (or disposal group) as held for sale are included in profit or loss even if the asset is (or the disposal group includes assets that are) measured at a revalued amount. The same applies to gains and losses on subsequent remeasurement (see below).

IFRS 5.23 Losses on a disposal group are allocated to the non-current assets in that group that are within the scope of the *measurement* requirements of IFRS 5 in the order of allocation required by IAS 36 (see 3.9). In the case of impairment losses allocation would be first to goodwill and then to other assets on a *pro rata* basis.

For example, a disposal group contains assets and liabilities that are not within the measurement scope of IFRSs (excluded assets) with a net carrying amount measured on the basis of the relevant standards of 270 (see above). The carrying amount of assets within the measurement scope of IFRS 5 is 900. The fair value less costs to sell of the disposal group as a whole is 1,000. A loss of 170 (900 compared with 730 (1,000 - 270)) is allocated to the assets within the measurement scope of IFRS 5 in the order of allocation required by IAS 36. The allocation is not restricted by the value in use or fair value less costs to sell of the individual assets as would be the case with an impairment recognised under IAS 36 (see 3.9).

IFRS 5.25 A disposal group continues to be consolidated while held for sale. Accordingly, revenue (e.g., from the sale of inventory) and expenses (including interest) continue to be recognised. However, assets held for sale are not depreciated or amortised.

On subsequent remeasurement

IFRS 5.15, 20-22 Subsequently, disposal groups and non-current assets are measured at their fair value less costs to sell, subject to a limit on the amount of any gain that can be recognised as a result of an increase in fair value less costs to sell before disposal. The maximum increase (and therefore gain) that can be recognised as a result of an increase in fair value less costs to sell is the cumulative amount of impairment losses recognised in accordance with IFRS 5 and previously in accordance with IAS 36. Impairment losses allocated to goodwill are included in determining the maximum.

IFRS 5.19 Immediately before each subsequent remeasurement of a disposal group, the carrying amount of liabilities and any assets excluded from the measurement requirements of IFRS 5 are remeasured in accordance with other applicable IFRSs. In our view, any gains and losses on this remeasurement are recognised in accordance with the relevant standards.

IFRS 5.37 Gains and losses on subsequent remeasurement of fair value less costs to sell are included in profit or loss regardless of whether the asset was (or the disposal group includes assets that were) previously measured based on revalued amounts.

IFRS 5.23 Gains and losses from remeasurement of a disposal group are allocated to the non-current assets in that group that are within the scope of the *measurement* requirements of IFRS 5 in the order of allocation required by IAS 36 (in the case of losses, first to goodwill and then to other assets on a *pro rata* basis).

IFRS 5.29 A disposal group continues to be classified as held for sale even when part of the group (e.g., inventory) is sold separately, as long as the remaining items in the group continues to meet the criteria.

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On disposal

IFRS 5.24 Any gain or loss not previously recognised by the date of sale is recognised on the derecognition of the non-current asset or disposal group.

Reclassification as held for use

IFRS 5.26 Assets (and disposal groups) are reclassified from held for sale to held for use if the asset no longer meets the criteria to be classified as held for sale.

IFRS 5.27 Upon reclassification as held for use a non-current asset is remeasured at the lower of its recoverable amount and the carrying amount that would have been recognised had the asset never been classified as held for sale. The calculation of this carrying amount should include any depreciation or impairments that would have been recognised had the asset not been classified as held for sale.

IAS 36.124, IFRS 5.27 Normally, reversals of impairments of goodwill are prohibited. In our view, reclassification as held for use and the requirement to remeasure upon reclassification may create one of the rare circumstances when reversals of goodwill impairment are recognised. This may occur if the recoverable amount of goodwill exceeds its carrying amount as a result of impairment losses recognised in respect of the held for sale disposal group that were allocated to goodwill.

IFRS 5.28 Any resulting adjustment is recognised in the income statement unless the asset was measured at a revalued amount prior to its classification as held for sale. In these cases, the adjustment is recognised as a revaluation increase or decrease (see 3.2 and 3.3).

Associates and jointly controlled entities

IAS 28.15, 31.43 When an interest in an associate or a jointly controlled entity classified as held for sale is reclassified as held for use, the equity method or proportionate consolidation is applied retrospectively from the date of its classification as held for sale. Financial statements for earlier periods that classify the investment as held for sale are amended accordingly. In our view, this amendment is made in the financial statements of the reporting period in which the change of classification occurs. To the extent that the amendment relates to earlier periods it is recognised as a prior period adjustment (i.e., the amendment is calculated retrospectively) and the opening balance of retained earnings and comparatives are restated (see 2.8).

5.4A.3 Discontinued operations

Classification

IFRS 5.32 The presentation of an operation as a discontinued operation is limited to a *component* of an entity that:

- represents a separate major line of business or geographical area of operations;
- is part of a co-ordinated single plan to dispose of a separate major line of business or geographical area of operations; or
- is a subsidiary acquired exclusively with a view to resale.

This area of IFRSs may be subject to future developments (see 5.4A.6).

IFRS 5.31 A component of an entity comprises operations and cash flows that can be distinguished clearly, both operationally and for financial reporting purposes, from the rest of the entity. A component that previously was held for use will have been one or more CGUs (see 3.9).

IAS 27.4 A subsidiary is an entity (including an unincorporated entity) that is controlled. In our view, a division may meet these criteria in some circumstances.

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IFRS 5.32, 13 Classification as a *discontinued operation* occurs at the earlier of the date that:

- the entity actually has disposed of the operation; and
- the operation meets the criteria to be classified as held for sale or is a disposal group that has ceased to be used.

IFRS 5.12, 34 Classification as a discontinued operation is *prohibited* when the criteria are met only *after* the balance sheet date. Instead, disclosures are required in the notes to the financial statements.

IFRS 5.34 Comparative income statement and cash flow information is represented each period on the basis of the classification of operations as discontinued or continuing operations at the current reporting date.

Measurement

There are no recognition or measurement impacts from classifying an operation as discontinued. However, a discontinued operation will include non-current assets or a disposal group or groups. Therefore, the measurement requirements for discontinued operations are those of the individual assets and liabilities or disposal group that comprise the component.

Presentation

IFRS 5.33 The results of discontinued operations are presented separately from continuing operations on the face of the income statement as a single amount. An analysis of this single amount is presented either on the face of the income statement or in the notes to the financial statements. Certain net cash flow information also is required.

IFRS 5.33 The analysis of the income statement result and cash flow information are not required for a disposal group that is a newly acquired *subsidiary* that is classified as held for sale on its acquisition.

IFRS 5.34 Comparative income statement (and cash flow) information is required and must be restated each period so that comparative information given in respect of discontinued operations includes all operations classified as discontinued at the current balance sheet date.

For example, if operation D is classified as discontinued in 2005, the 2004 comparatives are restated to present the comparative income statement and cash flow information in respect of D as discontinued.

Reclassification as continuing

IFRS 5.36 If the component ceases to be classified as held for sale (see 5.4A.2 concerning *Reclassification as held for use*), the related operations must be reclassified as continuing. The operations are presented as continuing in the current period and prior periods are restated consistently.

5.4A.4 Acquired exclusively with a view to resale

IFRS 5.11, 5.BC72 A non-current asset (or a disposal group) acquired exclusively with a view to its subsequent disposal is classified as held for sale if it meets the 'held for sale' criteria or if it is *highly probable* that it will meet those criteria within a short period after acquisition (usually three months). In our view, any non-current asset (or a disposal group) that satisfies the criteria to be classified as held for sale on its acquisition may be assumed to have been acquired exclusively with a view to its subsequent disposal.

IFRS 5.16 A non-current asset (or a disposal group) acquired exclusively with a view to its subsequent disposal is measured on initial recognition at the lower of:

- carrying amount had the asset (or disposal group) not been classified by the purchaser as held for sale (e.g., cost); and
- fair value less costs to sell.

This area of IFRSs may be subject to future developments (see 5.4A.6).

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Subsidiaries

IAS 27.13 Subsidiaries are consolidated even if they are held exclusively with a view to subsequent disposal and classified as held for sale.

IFRS 5.33(b), 39, 5.IG13 Consolidation requires the application of business combination accounting, including an acquisition date fair value exercise (see 2.6). Disclosure exemptions for disposal groups that are newly acquired subsidiaries and are classified as held for sale may simplify the application of these requirements. These exemptions allow certain analyses of income statement and balance sheet amounts to be omitted, reducing the need to determine acquisition date fair values of individual assets and liabilities. However, the acquisition date fair value of certain non-current assets and liabilities still may be required (e.g., a financial asset that is measured at fair value directly in equity).

Associates and jointly controlled entities

IFRS 5.11, IAS 28.13(a), 14, 31.42 An investment in an associate or jointly controlled entity is classified as held for sale on acquisition if the classification criteria are met. It is not equity accounted or proportionately consolidated.

5.4A.5 Transitional provisions

IFRS 5.43 The standard is effective for annual reporting periods beginning on or after 1 January 2005. The transitional provisions generally require prospective application from that date by current users of IFRSs. The transitional requirements for first-time adopters are dealt with in 6.1.

Current users of IFRSs

IFRS 5.43, 44 At the effective date of the standard (i.e., the beginning of the first annual period commencing on or after 1 January 2005) all non-currents assets or disposal groups that meet the criteria to be classified as held for sale on or before that date are reclassified and remeasured at that date (see 5.4A2).

In our view, any gain or loss is recognised in the income statement at the effective date.

IFRS 5.34, 44 In our view, the prospective application of the classification and measurement requirements does not override the requirement to represent income statement comparatives for continuing / discontinued operations, based upon the classification at the current reporting date.

IFRS 5.43 All entities are permitted to apply the standard to all non-current assets (or disposal groups) held for sale and operations discontinued after a date earlier than the effective date of IFRS 5, provided that the valuations and other information needed to apply the standard were obtained at the time those criteria originally were met.

5.4A.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

IFRS 5.BC 71 The definition of a discontinued operation differs from that under equivalent US GAAP requirements. The IASB intends to amend the definition, in consultation with the FASB, in order to achieve convergence in the short-term.

IFRS 5.BC 44, 5.BC45 The measurement of disposal groups on initial recognition at fair value less costs to sell as part of a business combination is to be reconsidered as part of the IASB's measurement project. This may result in further changes in this area.

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5.5 Related party disclosures

(IAS 24)

Overview

- **Related party relationships include those between entities when direct or indirect control exists, for example, subsidiaries, parents and entities under common control. Investments involving joint control or significant influence also create related party relationships.**
- **There are no special recognition or measurement requirements for related party transactions.**
- **Disclosure of related party *relationships* between parents and subsidiaries is required, even if there have not been any transactions between them.**
- **Comprehensive disclosures of related party *transactions* are required for each category of related party relationship.**

In December 2003, the IASB issued a revised version of IAS 24 *Related Party Disclosures*. The revised standard is effective for accounting periods beginning on or after 1 January 2005 and early adoption is encouraged. ***The following guidance is based upon the revised standard***.

5.5.1 Scope

IAS 24.3 Related party disclosure requirements apply to all entities, including parent entities, investors and joint venturers, in both their consolidated and separate financial statements. There are no exemptions from disclosure of inter-group transactions in the separate financial statements of a parent or its subsidiaries.

A state-controlled entity that applies IFRSs is not exempted from providing related party disclosures. Therefore, a state-controlled entity must disclose as related party transaction its transactions with other state-controlled entities.

Local rules and regulations often require an entity to provide certain related party information, for example, directors' individual remuneration. Specific legal requirements may supplement but cannot waive any requirement to provide related party disclosures under IFRSs (see 5.5.3).

Recognition and measurement

IAS 24 does not establish any recognition or measurement requirements for related party transactions. Related party transactions are accounted for in accordance with the requirements of relevant IFRSs. As an example, in an entity's individual financial statements, loans to other group entities are recognised and measured in accordance with IAS 39 (see 3.6) and the disclosures required by IAS 32 (see 5.6) are provided in addition to those required by IAS 24 (see 5.5.3).

Accounting for related party transactions must reflect their substance. It is not unusual for the accounting for related party transactions to reflect factors in addition to their legal form.

For example, share grants made directly by a shareholder of M to employees of M often should be accounted for as if the grant had been made by M (see 4.5A). As another example, when a shareholder forgives a loan to the entity, in most cases this would be accounted for as a capital contribution to the entity, and not as a gain on extinguishment (see 3.10).

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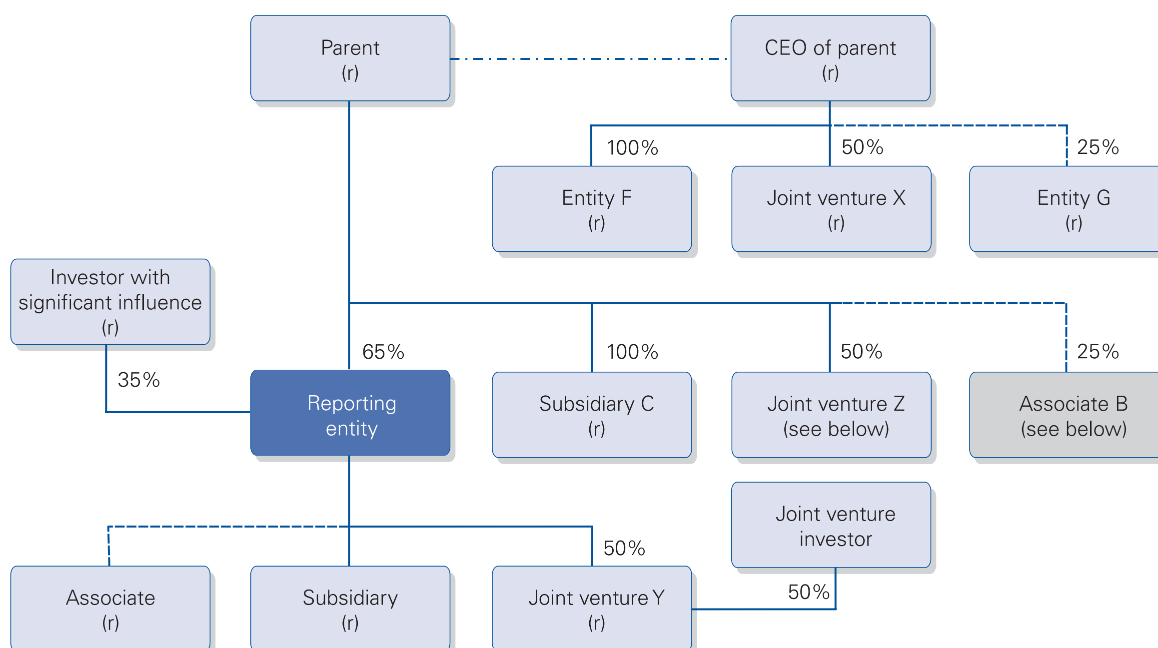
5.5.2 Identification of related parties

IAS 24.9 The definition of related parties includes relationships involving direct and indirect control (including common control), joint control and significant influence.

IAS 24.9 The definition is not restricted to entities; it also includes individuals, key management and post-employment benefit plans. For example, entities that are under common *control* of the same non-corporate shareholder (e.g., an individual, group of individuals or a trust) are related parties, even if the shareholder does not prepare consolidated financial statements.

The definition of related parties also includes close members of the family of an individual who is a related party. Close family members are those who may be expected to influence, or be influenced by, the individual in their dealings with the entity. They may include an individual's domestic partner or children, children of the individual's domestic partner, and dependants of the individual or the individual's domestic partner.

Examples of some related party relationships are illustrated below:



At least those parties marked (r) are parties related to the reporting entity under IFRSs.

IAS 24.9 The definition of a related party does not include an entity that is a joint venture or an associate of the parent or ultimate parent of the reporting entity (i.e., joint venture Z and associate B in the above diagram). However, an entity that is an associate or joint venture of key management of the parent or ultimate parent is a related party under IFRSs. Therefore, in our view, it is preferable to treat joint ventures and associates of the parent or ultimate parent as related parties, unless it is clear that the relationship has no current or potential impact on the entity's operations or results.

For example, when the parent in the above diagram has the ability to influence decisions and therefore pricing of transactions between the reporting entity and associate B, in our view disclosure of those transactions as related party transactions is appropriate.

A branch generally is an extension of the entity's activities. In our view, if a branch of a foreign entity prepares separate financial statements, the branch should disclose related party transactions and relationships, including those with its head office.

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Key management personnel

IAS 24.9 Key management personnel are those individuals that have authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly. The definition of key management personnel includes directors (both executive and non-executive) of an entity or its parent. In our view, key management of the ultimate parent also are related parties.

In practice, an entity may have more than one level of management. For example, there may be a supervisory board whose members have responsibilities similar to those of non-executive directors, a board of directors which set the overall strategy under which an entity operates, and a management team that implements those strategies within the authority delegated to it by the board. In most cases any director of either board, including non-executive directors, will be considered to be key management.

Key management is not limited to directors; in our view, other members of the management team also may be key management. We believe that an individual with significant authority and responsibility for planning, directing and controlling the activities of the entity should be considered to be key management personnel.

IAS 24.9(f) Entities under control, joint control or significant influence of key management (or their close family members) also are related parties of the entity. For example, Mrs Z is a director of G and considered to be key management. Mrs Z has joint control over a joint venture H. As influence over G and H come from the same individual, H is considered to be a related party of G. This also would be the case if a close family member of Mrs Z had joint control over H.

IAS 24.11 However, two entities are not related parties simply because they have a director, or other member of key management, in common. In the example above, if Mrs Z was a director of joint venture H, but as an individual did not have joint control or significant influence over H, G and H would not be related parties solely because Mrs Z is a director of both.

Each relationship is considered individually to assess whether a related party relationship exists. As another example, entity T is the administrator for several mutual funds and some of T's senior officers are directors of these funds. T receives an administration fee for its services, but has no ownership interest in the funds. In our view, the mutual funds will be related parties of T only if the senior officers are considered to be key management of T and individually, or as a group, exercise control, joint control or significant influence over the mutual funds. If the mutual funds are related parties of T, any administration fees paid by the mutual funds to T must be disclosed as related party transactions.

Post-employment benefit plans

IAS 24.9 Related parties include post-employment benefit plans that benefit an entity's employees or the employees of any entity that is a related party.

In certain jurisdictions the trustees of post-employment benefit plans are entirely separate from the sponsoring entity. In our view, these plans still are related parties.

Economic dependence

IAS 24.11, 14.69-71 An entity may be dependent, economically or operationally, on another party, for example, a major customer or supplier. This dependency does not create a related party relationship. However, additional information on these relationships and transactions may be relevant. Also, certain segment disclosures may be required about sales to major customers (see 5.2).

IAS 24.11 Providers of finance and similar entities are not related parties by virtue of their normal dealings with an entity, even though these parties may limit the actions of an entity or participate in its decision-making process. However, transactions in the ordinary course of business between

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related parties must be disclosed. For example, a banking entity would be required to disclose transactions with its finance provider that is part of the same banking group even if these services are provided on the same terms as to unrelated customers.

Government departments and state-controlled utilities also are required to provide disclosure of transactions with other government-controlled entities since these entities are under the common control of the government. For example, a state-controlled airline would disclose transactions and outstanding balances with the state-controlled telecommunication provider in respect of telecommunication services.

5.5.3 Disclosure

Control relationships

IAS 24.12, 1.126(c)

Parent and subsidiary relationships should be disclosed regardless of whether there have been any transactions between the parties. An entity should disclose the name of its parent and ultimate parent (if different). If the parent of (or significant investor in) the entity or the ultimate parent is an individual, that relationship also should be disclosed.

IAS 24.15

If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, an entity then discloses the name of the next most senior parent that does so.

An entity is not required to disclose relationships with other entities in a group. For example, A and B are owned and controlled by the same individual, X, and have the same directors. Each entity has numerous subsidiaries. B holds shares in A, but not enough to give B control of or significant influence over A, while A does not hold any shares in B. In A's separate financial statements, it discloses only its relationships with X and with A's own subsidiaries. A is not required to describe its *relationship* with B or any of B's subsidiaries. However, any *transactions* with B or its subsidiaries are disclosed as related party transactions.

Transactions and balances

IAS 24.9

Related party transactions are disclosed regardless of whether a price is charged. Therefore, disclosure is required in respect of guarantees, gifts or other non-reciprocal transfers of assets or services, asset swaps or other similar transactions between related parties.

As an example, entities E and F are related parties. F provides fund raising and promotional activities and makes use of E's employees to arrange these events. E does not charge F for these services. Accordingly, in both E and F's financial statements, the use of E's employees by F should be disclosed as a related party transaction.

Key management personnel compensation

IAS 24.16

Compensation of key management personnel (including non-executive directors) must be disclosed in total and analysed into its components (short-term, post-employment, other long-term, termination and share-based benefits). Disclosure of key management compensation generally is aggregated rather than presented separately for each individual director.

Payments by an entity may relate to services provided by the recipients to third parties. If an entity acts as an agent and makes payments to an individual on behalf of another party, in our view the entity only is required to disclose compensation paid as consideration for services rendered *to the entity*.

For example, Mr Y is a director of A. In addition to providing services to A, Mr Y provides services to B, a subsidiary of A. Mr Y is compensated by A both for the services performed for A as well as those performed for B, and B reimburses A for amounts paid to Mr Y on its behalf.

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In our view, in B's separate financial statements it discloses the amount that B pays to A in respect of the services performed by Mr Y for B as key management compensation (even though B pays this compensation to A and not directly to Mr Y). In A's separate financial statements, we believe that disclosure of key management compensation must include only the amount paid to Mr Y for services to A. A is not required to disclose amounts paid to Mr Y in respect of services provided to B. However, A also discloses the reimbursement received from B for Mr Y's services as a related party transaction.

In the consolidated financial statements, Mr Y is considered to be key management for both A and for the group as a whole. The compensation paid by A therefore relates to the key management services performed for the group and therefore Mr Y's total compensation (for services to both B and A) is disclosed.

In addition to key management's remuneration, an entity also discloses information about other transactions with key management, for example, loans, current account balances and interest paid or received.

Other related party transactions

IAS 24.17, 18

As a minimum, the following disclosures must be provided if there have been transactions between related parties:

- the nature of the related party relationship and information about transactions;
- the amount of the transactions;
- outstanding balances, their terms and conditions (including whether outstanding balances are secured);
- the nature of the consideration to be provided and details of guarantees given or received; and
- any allowance for doubtful debts and any amounts written off during the period.

IAS 24.4

In the consolidated financial statements, intra-group transactions are eliminated. In our view, an entity still is required to disclose portions of transactions with joint ventures or associates that are not eliminated on proportional consolidation or equity accounting.

IAS 24.18

Disclosure is provided separately for each category of related party. For example, sales to subsidiaries are not aggregated with sales to joint ventures.

IAS 24.22

Items of a similar nature may be disclosed in aggregate so long as aggregation does not obscure the importance of individually significant transactions. For example, in the individual financial statements of a subsidiary, regular purchases or sales with other subsidiaries may be aggregated. However, in our view, details of a significant disposal of fixed assets to a subsidiary should not be included in an aggregate disclosure of regular sales of goods to subsidiaries.

IAS 24.21

In practice many financial statements include a statement that related party transactions were made on terms equivalent to those that prevail in arm's length transactions. The fact that related party transactions are entered into on terms equivalent to those in an arm's length transaction does not remove any obligation to provide related party disclosures. This statement can be included in the financial statements only if it can be substantiated.

5.5.4 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.6 Financial instruments: presentation and disclosure

(IAS 32)

Overview

- **An instrument is a liability if the issuer could be obliged to settle in cash or another financial instrument.**
- **An instrument is a liability if it will or may be settled in a variable number of the entity's own equity instruments (e.g., equal to a specified value).**
- **Preference shares and similar instruments must be evaluated to determine whether they have the characteristics of a liability. Such characteristics will lead to classification of these instruments as debt.**
- **Compound instruments that have both liability and equity characteristics are split into these components.**
- **Qualitative disclosures are required in respect of financial risks and management's approach to managing these risks.**
- **The terms and conditions of, and accounting policies applied for, all financial instruments must be disclosed.**
- **The fair value of instruments not carried at fair value in the financial statements must be disclosed. In addition, disclosure is required about methods and significant assumptions used for determining fair value.**
- **The level of detail of the required disclosures will vary depending on the nature and extent of financial instruments.**

For ease of use, this section is based on the revised version of IAS 32 *Financial Instruments: Presentation and Disclosure* issued in December 2003 (and amended consequentially in March 2004). The revised standard is effective for accounting periods beginning on or after 1 January 2005 and early adoption is encouraged. The impact on the current version of IAS 32 of these amendments is discussed in a separate KPMG publication *Financial Instruments Accounting* (March 2004).

5.6.1 Classification as a liability or equity

Basic principle

IAS 32.11, 15-20 An instrument is classified as a liability (debt), when it contains an obligation to transfer resources (e.g., cash or other financial assets). Such an obligation may arise from a requirement to repay principal or to pay interest or dividends.

IAS 32.19 Any instrument that an issuer could be obliged to settle in cash or another financial instrument is a liability regardless of the manner in which it will be settled, the financial ability of the issuer to settle or the probability of settlement being required.

IAS 32.16 An instrument is classified as an equity instrument only if it does not contain any contractual obligation for the holder to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that potentially are unfavourable to the issuer.

IAS 32.18 These classification principles apply even if the instrument is in the legal form of a share. Thus preference shares might be classified as debt.

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IAS 32.18(a), 21, 32.AG26

Instruments classified as liabilities include the following:

- perpetual debt instruments;
- certain instruments that are redeemable at the option of the holder (e.g., redeemable preference shares);
- non-redeemable preference shares with fixed rate dividends that are not discretionary (see *Obligation to pay dividends* below);
- puttable instruments (see *Mutual funds, co-operatives and similar entities* below);
- subordinated liabilities; and
- contractual obligations that will be settled by issuing a variable number of own equity instruments.

IAS 32.AG13, 25, 26

Examples of equity instruments include non-redeemable preference shares or preference shares that are redeemable only at the option of the issuer, with discretionary dividends (see *Obligation to pay dividends* below) and ordinary share capital that has no right of redemption. This area of IFRSs may be subject to future developments (see 5.6.9).

Impact of share settlement

IAS 32.16(b)(i), 21, 32.AG27(d)

If an instrument will or may be settled in the issuer's own equity instruments, it is a liability if it includes a contractual obligation for the issuer to deliver a *variable number* of its own equity instruments.

This feature commonly is known as "shares to the value of". Liability classification follows from the fact that, from the holder's perspective, the return is fixed in the same way as if settlement was to be made in cash. As a result, the holder does not have an equity exposure as would be the case if the issuer was obliged to deliver a fixed number of shares.

IAS 32.16(b) 18C(b)

Also, if an instrument may be settled in own equity instruments (whether fixed or floating in number) or in cash or other financial assets at the option of the *holder*, the instrument is a financial liability. This is because an instrument may be classified as equity only if all settlement options would result in equity classification.

IAS 32.22 16C(b)

In the case of derivative instruments, only an instrument that requires settlement by delivery of a fixed number of own equity instruments in settlement of a fixed obligation is classified as equity. Any other settlement method, even at the choice of the issuer, results in liability classification.

Obligation to pay dividends

IAS 32.AG26

A requirement to pay dividends gives rise to an obligation (e.g., cumulative dividends on preference shares).

IAS 32.20

Dividends in respect of other instruments may be discretionary (i.e., there is no obligation to pay). For example, dividends on ordinary shares normally vary depending on the level of profitability and the entity has discretion as to whether to pay dividends and how much to pay. Although there may be an expectation that dividends will be paid if a certain level of profitability is achieved, this expectation is not a contractual obligation. Therefore, the entity is able to avoid the transfer of cash or another financial asset.

IAS 32.AG26

On the other hand, dividends payable at an agreed rate give rise to a contractual obligation. This does not change even if the agreement to pay is conditioned on the entity earning sufficient distributable profits.

If the dividends are cumulative, this suggests that the issuer may delay but cannot avoid payment of dividends. However, if the issuer has the discretion to avoid payment of the dividends under all circumstances until the winding-up of the entity, then the dividends are discretionary and do not give

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rise to an obligation. For example, if a non-redeemable preference share has a cumulative dividend, but payment is discretionary, then classification as equity is not precluded.

IAS 32.20 In some cases an instrument may be redeemable at the option of the issuer, but, through its terms and conditions, may indirectly establish an obligation for the issuer to transfer cash or other financial instruments to the holder. For example, the terms may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid transfer of cash or another financial asset only by settling the non-financial obligation, then that financial instrument is a financial liability.

Contingent obligations

IAS 32.25 An obligation to transfer resources is classified as a liability even if the obligation is contingent on uncertain future events outside the control of both the holder and the issuer, unless:

- the potential obligation to settle in cash (or another financial asset) is not genuine; or
- settlement in cash or another financial asset can be required only in the event of the liquidation of the issuer.

For example, Y issues a bond that is convertible automatically into a fixed number of ordinary shares when an initial public offering takes place. The offering is planned for two years time. The bond is redeemable only if the initial public offering does not take place. Because the bond potentially is redeemable in cash, the bond is recognised as a liability regardless of how unlikely Y considers cash settlement to be.

Compound instruments

IAS 32.29, 32.AG31 An instrument that contains both debt and equity elements (e.g., a convertible bond or convertible or redeemable preference shares) is a compound instrument.

IAS 32.28 Compound instruments are allocated between their debt and equity components (split accounting).

IAS 32.30 The classification (and allocation) is made at initial recognition and is not revised as a result of a change in the likelihood that a conversion option will be exercised.

Measuring debt and equity components

IAS 32.31 The carrying amount of a compound instrument should be allocated between its debt and equity components on initial recognition so that the liability is recognised at its fair value. The equity component is the residual. The allocation is made as follows:

- the amount allocated to the liability element is the present value of the future interest and principal cash flows, discounted at a rate applicable to a similar liability without an equity component. The value of any embedded derivatives, other than the equity feature (the embedded call represented by the conversion feature), is included in the amount allocated to the liability; and
- the remaining issue proceeds are allocated to the equity element.

For example, an entity issues 2,000 convertible bonds at the start of year one. The bonds have a three-year term, and are issued at par with a face value of 1,000 per bond, giving total proceeds of 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of six per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is nine per cent.

The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component.

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The present value of the liability component is calculated using a discount rate of nine per cent (the market interest rate for similar bonds having no conversion rights) as shown below.

Present value of the principal – 2,000,000 payable at the end of three years	1,544,367
Present value of the interest – 120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

Accounting for early redemption

IAS 32.AG33

On early redemption of a convertible instrument, the redemption payment should be allocated to the liability and equity components using a method consistent with the method initially used to allocate the instrument between its debt and equity components. In other words, the fair value of the liability component is compared to its carrying amount, giving rise to a gain or loss on redemption that is recognised in income. The remainder of the redemption payment paid is recognised in equity.

Accounting for conversion

IAS 32.AG32

On conversion of a convertible instrument, the entity derecognises the liability component (which is extinguished when the conversion feature is exercised) and recognises the same amount as equity. The original equity component remains as equity (although it may be transferred within equity). No gain or loss is recognised in the income statement.

Amendment to induce early conversion

An entity may amend the terms of a convertible instrument to induce early conversion, for example, by offering a more favourable conversion ratio in the event of conversion before a specified date.

IAS 32.AG35

The difference between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms, and the fair value of the consideration the holder would have received under the original terms, is recognised as a loss in profit or loss.

Mutual funds, co-operatives and similar entities

IAS 32.18(b)

Financial instruments that give the holder the right to "put" them back to the issuer for cash or other financial assets ("puttable instruments") are financial liabilities of the issuer.

IAS 32.18(b)

This applies even when the amount of cash or other financial assets is determined on the basis of an index or other variable that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of the issuer. This area of IFRSs may be subject to future developments (see 5.6.9).

For example, investors in many mutual funds, unit trusts, co-operatives and similar entities have the right to redeem their interests in exchange for cash that is equivalent to their share of the net asset value of the entity. This gives the issuer (the fund) a contractual obligation and therefore these instruments are required to be classified as a liability. This requirement often means that these entities do not show any equity.

IAS 39.AG31, 32

In addition, the amount payable to investors for puttable shares changes as the underlying net asset value changes. This means that the instrument has an embedded derivative feature that is not clearly and closely related to the host debt contract (see 3.6). Therefore, the entire combined instrument must be measured at fair value with gains or losses reported in the income statement; or the embedded derivative must be separated and accounted for separately from the host debt contract.

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Debt with share purchase warrants

As a result of split accounting (see *Compound instruments* above) it is irrelevant whether share purchase warrants are detachable from debt. The share purchase warrants must be split out and accounted for as equity by the issuer whether or not the warrants are detachable.

Derivatives on own equity

IAS 32.4(a), 16 A derivative on own equity, or equity of a consolidated subsidiary, should be classified as a gross liability, a derivative asset or liability or an equity instrument applying the principles discussed above.

IAS 32.22, 32.AG14, 27(a) A derivative on own equity that will be settled *only* by exchanging a fixed number of own shares for a fixed amount of cash or other financial assets (e.g., a written option to sell own shares that requires gross physical settlement) is classified as equity. The initial amount paid or received is recognised directly in equity and the instrument is not remeasured for changes in the value of the instrument.

IAS 32.16, 26, 32.AG27(b) A derivative on own equity that will *or may* be settled net in cash, or in a variable number of own shares to that net cash value, is treated as a derivative and measured at fair value with all gains and losses from changes in fair value recognised immediately in the income statement. Examples of derivatives on own equity that would be treated as derivatives are a call option or a forward to sell own shares that may be net settled at the option of either the entity or the other party.

IAS 32.23, 32.AG27 A derivative on own equity that contains a potential obligation for the entity to deliver cash, a variable number of own shares or a fixed number of shares to satisfy a variable obligation (e.g., a forward to buy own equity instruments or a written put on own equity instruments) gives rise to a financial liability even if the derivative itself is an equity instrument. An amount equal to the present value of the amount payable (e.g., the forward purchase price or option exercise price) is reclassified from equity to liabilities. If the liability is required to be remeasured then it is measured at the present value of the potential outflow and all changes in value are recognised immediately in the income statement. In effect, the debit to equity reflects the future purchase of treasury shares but is recognised immediately. Interest is accrued on the liability. This applies regardless of any settlement options.

5.6.2 Offset

IAS 32.42 A financial asset and financial liability should be offset and reported net when the entity has a legally enforceable right to offset and it intends either to settle on a net basis or to settle both amounts simultaneously.

IAS 32.49(b) When a financial asset and financial liability are with different counterparties, it is unusual for a legal right of offset to exist unless both counterparties have agreed to the arrangement.

IAS 32.49(a) The individual instruments that when viewed together form a synthetic instrument usually do not qualify for offset. For example, in the case of a fixed rate liability and a fixed-to-floating interest rate swap that together form a synthetic floating rate liability, there generally is no legal right of offset of the swap accruals and the interest payments on the liability and the settlement of the liability and realisation of the swap do not occur simultaneously.

Assets and the corresponding liabilities of brokerage entities often meet the requirements for offset based on the agency nature of the business.

IAS 32.42 When a transfer of financial assets does not qualify for derecognition (see 3.6), the associated liability and the corresponding assets should not be offset.

Derivative assets and liabilities generally do not meet the offset criteria, even if they are issued by the same counterparty and relate to the same underlying risk, or if there is a master netting agreement in place. Therefore, most derivative assets and liabilities are presented on a gross basis on the face of the balance sheet.

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IAS 32.50 An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. A master netting arrangement commonly creates a right of set off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless the offsetting criteria are met (i.e., the specified event of default has occurred).

5.6.3 General disclosure considerations

IAS 32.4 The disclosure requirements apply to all entities and all financial instruments including those relating to leases and own equity instruments. There also is no exemption for short-term receivables or payables.

KPMG's *IFRS Illustrative financial statements* series contains example disclosures. Therefore, example disclosures on financial instruments are not given in this chapter. The discussion below focuses only on the most common application issues related to disclosures. Full details of disclosure requirements are provided in the standards themselves and are reproduced by topic in KPMG's *IFRS Disclosure checklist*.

IAS 32.53-55 The risk disclosure requirements are expressed in general terms. The nature and extent of risk management disclosures, as well as the level of detail that is appropriate, depends on the significance of financial instruments to the reporting entity. Neither the format of the information to be disclosed nor its location in the financial statements is prescribed.

IAS 32.53,57 Disclosures should include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the financial instruments. Entities also should provide a discussion of the extent to which financial instruments are used, the business purposes served and the associated risks.

IAS 32.56 Disclosure also is required of management's financial risk management objectives and policies.

IAS 32.52 Disclosure requirements refer directly to market risk (including interest rate risk, foreign currency risk and price risk), credit risk, liquidity (funding) risk and cash flow interest rate risk disclosures. While the standard only lists specific disclosure requirements in respect of interest rate risk and credit risk, these requirements are sufficiently broad to encompass all risks. Therefore, in our view, appropriate disclosures regarding all financial risks should be provided.

IFRS 4.A IFRS 4 provides a definition of financial risk (to distinguish financial risk from insurance risk). The definition of financial risk in IFRS 4 is the risk of a possible future change in at least one of: a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index. Financial risk also includes risk of change in other variables, provided that a non-financial variable is not specific to a party to the contract. Once an entity adopts IFRS 4, if any financial risks, as defined, is embedded in a financial instrument, then these are subject to the disclosure requirements of IAS 32.

In our view, disclosure of non-financial risk exposures such as operational risks also is desirable if these are significant.

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5.6.4 Risk disclosures

Interest rate risk

IAS 32.67 For each class of interest-bearing financial assets and financial liabilities, an entity must disclose the earlier of the contractual repricing dates or maturity dates and the effective interest rates.

IAS 32.71 A distinction must be made between instruments that are:

- exposed to fair value interest rate risk (i.e., fixed rate instruments);
- exposed to interest rate cash flow risk (i.e., floating rate instruments or instruments with an interest rate that is reset as market rates change); and
- instruments that are not directly exposed to interest rate risk, such as some investments in equity instruments.

IAS 32.70, 74, 75 The contractual repricing dates or maturities can be disclosed using a matrix presentation format. For fixed interest-bearing assets and liabilities a maturity schedule is recommended, while variable interest-bearing financial instruments can be clustered in a repricing schedule. In addition, it is recommended that an entity provides further information about its exposure to interest rate risk by presenting a sensitivity analysis and / or including information about expected repricing or maturity dates, when these differ significantly from the contractual dates.

In our view, it also is acceptable to use other appropriate risk measurements such as value at risk.

IAS 32.72 The effective interest rate disclosure requirements apply to debentures, notes and similar monetary financial instruments involving future payments that create a return to the holder and a cost to the issuer for the time value of money. These disclosure requirements do not apply to non-monetary instruments (e.g., equity securities, or derivatives).

In our view, for floating rate instruments, the effective interest rate disclosed should include the level of the referenced base rate as at the balance sheet date.

IAS 32.67, 72 The effective interest rates disclosed should not take into account the effect of derivatives held to manage the interest rate risk. The effect of such derivatives should be disclosed separately.

IAS 32.73 In circumstances when the entity is exposed to interest rate risk as a result of a transaction in which no financial asset or financial liability is recognised in its balance sheet, the entity must disclose information that permits users of its financial statements to understand the nature and extent of its exposure. For example, when a bank has a commitment to lend funds at a fixed interest rate the stated principal, interest rate, term to maturity of the amount to be lent, and the significant terms of the commitment giving rise to interest rate risk normally should be disclosed.

Currency risk

IAS 32.52, 56, 57 There are no specific disclosure requirements in respect of currency risk. However, there is a general requirement for a discussion of risk exposures and management's approach to managing those risks; therefore, in our view, a discussion of currency risk should be provided. In addition, the requirements relating to the general terms and conditions of financial instruments would require disclosure of the currency in which such instruments are denominated.

In our view, similar disclosures to those in respect of interest rate risks should be provided if there is significant foreign currency exposure. Such disclosures may start with the disclosure of the net foreign currency position in different currencies (e.g., a table showing the net foreign currency monetary position for each currency relevant to the entity) and go on to show a sensitivity analysis of its foreign currency exposure.

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Other price risk

There are no specific disclosure requirements in respect of other price risks. However, some disclosure may be necessary to satisfy the requirement to disclose the general terms and conditions of financial instruments.

In our view, if an entity is exposed to significant price risk, such as equity or commodity risk, then this fact should be disclosed and quantitative disclosures are strongly recommended.

Liquidity risk

IAS 7.50(a), 32.60(a)

Information about the maturity of financial instruments must be disclosed. It is highly recommended, but not required, to disclose additional information about the liquidity status of the entity. Such information may include unused loan commitments and details about the entity's liquidity management policies. Any significant debt covenants must be disclosed and disclosure is encouraged of the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.

Credit risk

IAS 32.76(a), 77, 82

For each class of recognised financial assets and other credit exposures (including unrecognised exposures such as guarantees), an entity must disclose the maximum loss that it would suffer if the other party failed to perform, without taking account of any collateral. In our view, the carrying amount of recognised financial assets generally represents the gross credit exposure of such assets. For derivatives, we recommend that disclosure of the notional amount or underlying also be provided.

IAS 32.76(b), 83-85

In addition, any concentrations of credit risk must be disclosed. To comply with this requirement, the amount attributable to counterparties that share similar characteristics, together with the nature of that concentration characteristic (e.g., the particular activity, region or creditworthiness or a significant exposure to a single counterparty) should be disclosed. For example, concentrations of credit risk may be disclosed with respect to lease financing, country-specific lending or loans to sub-prime borrowers. In our view, the disclosure should distinguish between concentrations that relate to recognised financial assets and those that relate to unrecognised exposures to enable the amounts included in the disclosures to be reconciled to amounts shown in the balance sheet.

IAS 32.77

Although it is not required, an entity is allowed to disclose information about the expectation of future credit losses. This information usually contains disclosure about expected and unexpected loss on a portfolio basis disregarding whether any loss has already been incurred or not. Generally, this information is determined on a product basis rather than on an overall assessment.

5.6.5 Balance sheet presentation of financial instruments

IAS 32.55

There is no requirement to present the categories of financial instruments (e.g., available-for sale, held-to-maturity, etc., see 3.6) as separate line items on the balance sheet. In practice, most entities present financial instruments in the balance sheet according to their nature (e.g., as debt or equity securities or long-term investments) and describe the line items accordingly.

IAS 32.55

Generally, instruments that are measured at cost or amortised cost and those that are measured at fair value are presented as separate line items. However, in our view, in certain cases instruments with different measurement bases may be included in the same line item, for example, a financial instrument host contract that is carried at amortised cost and a separable embedded derivative that meet the offset criteria (see 5.6.2) or an instrument normally carried at amortised cost that is the hedged item in a fair value hedge and other similar instruments that are not hedged. In these cases, we believe that the notes to the financial statements should identify the carrying amounts of instruments carried at fair value and those carried at amortised cost respectively that are combined in a single balance sheet line item.

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In our view, an appropriate description should be used for instruments that are designated as at fair value through profit or loss, but which are not held for trading purposes, for example: "Debt securities carried at fair value through profit or loss". We believe that the amount of these instruments should be disclosed separately from instruments that are held for trading purposes either on the face of the balance sheet or in the notes to the financial statements.

5.6.6 Balance sheet classification of financial instruments

Trading securities should be presented in the financial statements as current assets.

IAS 1.57, 60 In our view, to comply with the general principles for balance sheet classification (when an entity presents a classified balance sheet, see 3.1). Instruments designated as at fair value through profit or loss and available-for-sale instruments should be classified as current assets if they are expected to be realised within 12 months of the balance sheet date; otherwise they should be classified as non-current assets.

5.6.7 Disclosures of specific instruments and transactions

Terms and conditions

IAS 32.60(b) For each class of financial asset, financial liability and equity instrument, whether on- or off-balance sheet, an entity is required to disclose information about the amount and nature of the instruments, including significant terms and conditions. Furthermore, information should be provided as to whether regular way purchases and sales are accounted for at trade date or at settlement date (see 3.6).

IAS 32.63 There is no mandated level of detail for this disclosure and the type of information that is required will depend on the nature of the instruments. The following disclosures are suggested, among others: the principal, notional or similar amount; maturity; amount and timing of future cash flows; stated rate of interest or return; currency; settlement information; and collateral held or pledged.

Fair value

Methods and assumptions

IAS 32.92, 93 An entity must provide detailed disclosures of the methods used to determine the fair values of financial assets and financial liabilities and the significant assumptions made in the application of those methods. These disclosures must be made separately for significant classes of financial assets and financial liabilities. Significant assumptions that may require disclosure include: prepayment rates; rates of estimated credit losses; and interest or discount rates. The disclosures must specify whether fair value was determined by reference to active market prices or using a valuation technique.

IAS 32.92(c), (d) When fair values are determined using a valuation technique, the disclosures must indicate whether or not this technique was based on assumptions that are supported by observable market prices or rates. In addition, the total amount of the change in fair value estimated using a valuation technique and recognised in profit or loss for the period must be disclosed.

Instruments measured at cost or amortised cost

IAS 32.86 The fair values and carrying amounts of all classes of financial assets and liabilities that are not measured at fair value on the balance sheet must be disclosed so that the fair values can be compared to the corresponding carrying amounts in the balance sheet.

The carrying amounts of short-term receivables and payables are likely to approximate their fair values in a low interest rate environment where the effect of discounting is not material. In such cases it is not necessary to disclose these instruments' fair values. However, the fair values of long-term liabilities and receivables carried at amortised cost must be disclosed.

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Instruments for which a fair value is not reliably measurable

IAS 32.90 If an entity has investments in unquoted equity instruments, or derivatives linked to such equity instruments, and any such instruments are measured at cost because it is not possible to estimate the fair value of the instrument reliably (see 3.6), then this fact must be disclosed together with a description of the instrument, its carrying amount and an explanation of why fair value cannot be measured reliably. If possible, the range of estimates within which fair value is likely to lie also must be disclosed.

For example, "X holds a 15 per cent investment in I, an Internet start-up company. The carrying amount of this investment is its cost of 350,000. There is no market for this investment and there have not been any recent transactions that provide evidence of its current fair value. In addition, discounted cash flow techniques yield a wide range of fair values due to the uncertainty regarding future cash flows based on the high risk nature of the industry. Therefore, discounted cash flow techniques do not provide a reliable measure of fair value. Estimated fair values, based on discounted cash flow techniques, range from 300,000 to 450,000".

IAS 32.90 Also, for instruments carried at cost (because their fair value is not reliably measurable) that are sold during the period, it is necessary to disclose the amounts for which they were sold and their carrying amounts. This disclosure is required on an item-by-item basis. For example: "During the current year Z sold a 12 per cent investment in K, an unlisted Internet start-up company. This investment was measured at its cost of 65,000. The proceeds from the sale were 250,000 and a gain of 185,000 was recognised".

IAS 32.BC35 The disclosure requirements reflect a view that the fair value of all financial instruments, with the exception of unquoted equity instruments and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, is reliably determinable.

Collateral

IAS 32.94(b) An entity that has pledged its financial assets as collateral for liabilities and contingent liabilities must disclose the carrying amount of these assets pledged as collateral, as well as significant terms and conditions relating to these assets.

IAS 32.94(c) When an entity has accepted collateral that it is entitled to sell or repledge in the absence of default by the owner, it must disclose:

- the fair value of the collateral accepted (financial and non-financial assets);
- the fair value of such collateral sold or repledged and whether the entity has an obligation to return it; and
- any significant terms and conditions associated with its use of this collateral.

Derivatives and hedging

IAS 32.63 Examples of the terms and conditions that should be disclosed for derivatives include:

- the principal or notional amount (i.e., the amount on which future payments are based);
- the amounts included in the balance sheet in assets and liabilities; and
- the remaining period at the balance sheet date to the contractual maturity date.

An entity also must disclose in the notes any netting agreements or collateralised derivatives that it has entered into.

IAS 32.56 Disclosure is required of the policies for hedging each main type of forecast transaction for which hedge accounting is used.

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IAS 32.58 Separate qualitative and quantitative information must be disclosed for fair value hedges, cash flow hedges, and hedges of a net investment in a foreign entity including:

- a description of the hedge (i.e., identification of whether the hedge is a cash flow hedge, a fair value hedge or a hedge of a net investment in a foreign entity). In our view, a description of the hedge relationship also should be given;
- a description of the financial instruments designated as hedging instruments and their fair values at the balance sheet date; and
- the nature of the risks being hedged.

For example: "Foreign currency forward contracts with a fair value of 720,000 are used to hedge the cash flow exposures arising from US dollar / euro exchange rate fluctuations on forecast US dollar sales over the next six months. Cash flow hedge accounting is applied to these forward contracts".

IAS 32.58(a), 59 In addition, in respect of cash flow hedges, the following information must be disclosed:

- the timing of any hedged uncommitted but highly probable future transactions and when they are expected to affect the determination of profit or loss;
- a description of any forecast transaction that no longer is expected to occur for which hedge accounting has been used; this disclosure must be provided in both the interim and annual financial statements that include the period when hedge accounting was stopped; and
- hedge gains and losses reported directly in equity and those transferred out, distinguishing between transfers to the income statement and adjustments to the cost of non-financial assets.

IAS 32.57, 65 In our view, when hedge accounting is not applied, either because an entity chooses not to apply hedge accounting or because the criteria for hedge accounting are not met, information should be provided to explain the relationship between derivatives and the transactions for which they are an economic hedge. We believe that this should be done to enable users of the financial statements to understand the extent to which risk is altered through the use of the derivatives.

IAS 32.42 IFRSs do not contain any specific guidance on the presentation of gains and losses on derivatives (including derivatives designated as hedging instruments) in the income statement. In our view, gains and losses on qualifying hedging instruments may be presented in the same line item in the income statement as gains and losses on the hedged item. However, in the balance sheet the hedging instrument and the hedged item must be presented separately. The items may not be offset unless the offset criteria are met (see 5.6.2).

In our view, swap accruals may be included either in the carrying amount of the related swap or with other accruals.

Gains and losses on available-for-sale financial assets

IAS 32.94(h)(ii) Fair value adjustments on available-for-sale financial assets recognised directly in equity, and the amounts transferred from equity during the period, must be disclosed. In addition, gains and losses on available-for-sale instruments must be distinguished between those that are realised (gains and losses on derecognition) and those that are not (e.g., impairment losses, revaluations).

Derecognition

IAS 32.94(a) If an entity has entered into an arrangement that does not qualify as a transfer or has transferred a financial asset, but continues to recognise that asset in its entirety or to the extent of the entity's continuing involvement therein (see 3.6), it should disclose:

- the nature of the asset;
- the nature of the risks and rewards of ownership to which the entity remains exposed;

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- the carrying amount of the asset and of the associated liability, when the entity continues to recognise the full amount of the asset; and
- the total amount of the asset, the amount of the asset that the entity continues to recognise and the carrying amount of the associated liability, when the entity recognises the asset to the extent of its continuing involvement.

5.6.8 Presentation of embedded derivatives

There is no specific guidance on the presentation of embedded derivatives and the related host contracts.

In our view, when an embedded derivative is not required to be accounted for separately (see 3.6), the embedded derivative should be presented in the same line item as the host contract. However, embedded derivatives that are not presented separately in the balance sheet should be disclosed.

When an embedded derivative is accounted for separately (see 3.6), an issue arises as to whether the embedded derivative should be included in the same line item as the host contract, on the basis that the two instruments are subject to the same contract, or whether the derivative should be presented separately, together with other derivative instruments. In our view, if the host contract is a financial instrument, a separable embedded derivative and the host contract should be presented on a net basis because they meet the offset requirements (see 5.6.2), including net settlement (i.e., the host and separated embedded derivative are part of one contract that has a single (net) settlement).

5.6.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

The IASB has a project on its agenda on financial risk disclosures and other amendments to financial instrument disclosures. The project began as a project to revise IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, but its scope was extended to cover financial risk disclosure requirements in all entities. An exposure draft is expected in the latter half of 2004.

IFRIC has issued Draft Interpretation D8 *Members Shares in Co-operative Entities* on the application of the liability and equity classification principles in IAS 32 to the capital of co-operative entities and similar financial instruments. The interpretation proposes that limits on redemptions that are expressed in terms of a proportion of the issued or paid-in capital should be reflected on a portfolio basis. Consequently, it is proposed that the capital of such entities would be classified as equity to the extent that there are prohibitions against redemption.

The IASB currently is considering the application of the classification as financial liabilities or equity of shares puttable at a *pro rata* share of the fair value of the residual interest in the issuer, including certain types of partnership capital. The outcome of these discussions is not yet clear.

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5.7 Non-monetary transactions

(IAS 16, IAS 18, IAS 38, SIC–13, SIC–31)

Overview

- **Generally, exchanges of similar assets do not result in the recognition of a gain or revenue.#**
- **Donated assets may be accounted for in a manner similar to government grants, unless the transfer is, in substance, an equity contribution.**

Forthcoming requirements

In December 2003, the IASB issued a revised version of IAS 16 *Property, Plant and Equipment*. The revised standard is applicable for annual periods beginning on or after 1 January 2005 and earlier application is encouraged. In March 2004, the IASB issued a revised version of IAS 38 *Intangible Assets*. The revised standard is applicable prospectively from 31 March 2004 with three exemptions (see 3.3). Where an existing requirement is discussed that will be changed by the revised standards, it is marked with a # and the impact of the change is explained in the accompanying boxed text. In particular, the revised standards require that all property plant and equipment and intangible assets received in exchange for non-monetary assets be measured at fair value, subject to certain criteria.

5.7.1 Introduction

When addressing non-monetary transactions the two most typical issues are whether to:

- measure the exchange based on historical cost or fair value; and
- recognise revenue, gains or losses.

While revenue would not be recognised for exchanges measured at historical cost, measuring an exchange at fair value does not always result in recognising revenue for the transaction.

5.7.2 Exchanges of assets

IAS 16.21 (1998), 38.34 (1998)

When assets exchanged are dissimilar, the transaction gives rise to a gain or loss, calculated by reference to the fair value of the asset surrendered. The cost of the asset acquired is equal to the fair value of the asset given up, adjusted by any cash transferred.

IAS 16.22 (1998), 38.35 (1998)

Exchanges of non-monetary assets of a similar nature and value do not give rise to revenue or gains since the earnings process is incomplete; the acquired asset is recorded at the previous carrying amount of the asset given in exchange#. Items are similar when they have a similar fair value and a similar use in the same line of business.

SIC 13.5(c)

In our view, when a group of items is exchanged, each of the components of the group should be similar to a component of the other group. The assessment of similarity should not be made with respect to the group as a whole (e.g., total fair value received and delivered).

IAS 16.22 (1998)

Negotiating an exchange of similar assets may provide evidence that the asset to be exchanged is impaired, if the fair value of the asset received is less than the carrying value of the asset given up. If the asset surrendered is impaired then that impairment loss must be recognised.

Forthcoming requirements

IAS 16.24-26, 38.45-47

Under the revised standards all property, plant and equipment and intangible assets received in exchange for non-monetary assets must be measured at the fair value of the assets exchanged unless the exchange transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measurable. Commercial substance is assessed by considering the extent to which future cash flows are expected to change as a result of the transaction.

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Measurement of an exchange at fair value will result in recognition of a gain or loss based on the carrying value of the asset surrendered. Whether or not revenue is recognised will depend upon whether the transaction is incidental to the main revenue generating activities of the entity (see 4.1 and 4.2).

Interests in joint ventures

SIC 13

There are specific requirements in IFRSs regarding contributions of non-monetary assets in exchange for an interest in a jointly controlled entity. See 3.5 for a discussion of these requirements.

5.7.3 Revenue recognition – barter transactions

IAS 18.12, 1.34

Revenue is recognised by an entity when goods or services are sold in exchange for dissimilar goods and services, unless the transaction is incidental to the entity's main revenue-generating activities. Revenue is measured as the fair value of the goods or services received, including any cash or cash equivalents received. However, when goods and services are exchanged for goods or services that are similar in nature and value, the exchange is considered a transaction that does not generate revenue#.

Typical examples of barter transactions are transactions involving commodities such as wheat or oil, or advertising barter transactions.

For example, a natural gas company in Russia might sell gas to another Russian company and receive in exchange a quantity of steel tubing, items the customer itself received in other barter transactions. The natural gas company then might deliver the steel tubing to the government in lieu of a cash payment for taxes. In these cases the items exchanged are dissimilar and the natural gas company recognises revenue equal to the fair value of the steel tubing received. If the fair value of the items received cannot be determined reliably, the revenue is measured by reference to the fair value of the gas delivered.

In our view, the determination of whether or not items are similar should be made using the criteria for exchanges of assets (see 5.7.2). Therefore, we believe that items are similar when they are used for the same purpose in the same line of business and have a similar value#.

Forthcoming requirements

The similarity test in IAS 18 for barter transactions was not altered when the revisions to IAS 16 and 38 to introduce a commercial substance test in place of a similarity test. In our view, the commercial substance test applies only when assets held for use, rather than held for sale, are exchanged.

Advertising barter transactions

SIC 31

Entities may enter into barter transactions for advertising services. Revenue is not recognised when similar advertising services are exchanged. As an example, an exchange of banners between two travel agent Web sites is likely to be considered an exchange of similar services that does not qualify for revenue recognition.

In our view, advertising services involving different media generally would be considered dissimilar.

In our view, transactions when the items exchanged share some, but not necessarily all, of the following characteristics, normally are considered to be similar transactions for which revenue would not be recognised:

- target groups;
- prominence (page on Web site, location of page, size of advertisement, etc.);
- length of time the advertisement is displayed;
- timing (season of year, time of day, times per week, etc.); and
- exposure.

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In our view, examples of services generally considered dissimilar include:

- barter of airtime (advertising space) between a TV channel and a radio channel; and
- barter of airtime (advertising space) between TV channels with different audiences (e.g., different target groups or geographical areas).

SIC 31.5 Generally, revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of the advertising services *received*. Therefore, advertising revenue obtained in a barter transaction should be measured at the fair value of the advertising services, *provided* that fair value can be measured reliably. The measurement of advertising services provided is considered to be reliable if it is determined by reference to *non-barter* transactions that:

- involve advertising similar to that in the barter transaction;
- occur frequently;
- represent a predominant number of transactions and amount compared to all similar transactions;
- involve cash or other consideration that can be measured reliably; and
- do not involve the same counterparty.

When an entity meets the criteria above to recognise barter advertising revenue and the amount of revenue can be measured reliably, revenue is recognised when the advertisement appears before the public, for example, when the commercial is broadcast.

As an example, a radio station enters into an agreement with a television station. The radio station will run three advertisements for the television station on its radio station (for which a third party would have to pay 15,000), while the television company will broadcast two advertisements on the television channel. The normal cost of the television advertisements also is 15,000. In our view, these are dissimilar services and both parties should recognise revenue.

At year-end, both advertisements had been broadcast on the television channel, but only two of the advertisements had been broadcast on the radio station. The third radio advertisement, with a value of 5,000, will be broadcast in the following reporting period. The radio station accounts for the transaction as follows:

	Debit	*Credit*
Advertising expense	15,000	
Barter advertising revenue		10,000
Deferred income		5,000

During the following period, when the third advertisement is broadcast on the radio station, the radio station will recognise the deferred income of 5,000 as revenue.

5.7.4 Donated assets

An entity may receive assets from third parties for no consideration. When assets are transferred to the entity by the government, these transfers normally meet the definition of a government grant (see 4.3).

F.70(a) Assets or resources transferred to an entity by a shareholder for no consideration may be an equity contribution, which would be accounted for directly in equity (see 3.10).

IFRSs do not provide any guidance on accounting for assets or resources transferred to an entity by a party other than a shareholder or a government (via a government grant). Gifts without conditions are likely to be rare in an arm's length relationship. In our view, if conditions are

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attached to a non-reciprocal transfer, it may not be appropriate to recognise a gain immediately; instead, any gain should rather be deferred until the conditions are satisfied.

In our view, even though these transactions do not meet the definition of a government grant, government grant accounting should be applied by analogy to non-reciprocal non-monetary contributions by third parties other than shareholders or governments. The donation is recognised as income over the periods necessary to match it with the costs for which the contribution is intended to compensate.

IAS 20.23, 24 Therefore, assets transferred or donated to an entity may be measured either at the fair value of the assets received or, alternatively, at nominal value. In our view, it is preferable to measure these transactions at fair value. The resulting income should be deferred and recognised in income on a systematic basis.

Non-profit organisations

Donations often are received by charitable organisations and may be in the form of cash, goods, services or pledges (promises to pay at a future date). Donations may be "earmarked", for example, the donor requests that the donation be used for a particular purpose.

There is no specific guidance in IFRSs on contributions received by non-profit organisations. In our view, guidance may be obtained from the accounting for government grants (see 4.3) and discussions of the G4+1 on *Accounting by Recipients for Non-Reciprocal Transfers, Excluding Contributions by Owners: Their Definition, Recognition and Measurement*.

Non-reciprocal transfers are transfers of resources from one party to another when the transferors do not receive approximately equal value in return. Non-reciprocal transfers include transfers such as gifts, donations, government grants and taxes. They may be received as cash, or as other assets, or as reductions in liabilities (e.g., forgiven loans), and may or may not have conditions or restrictions attached.

In our view, non-reciprocal transfers without conditions attached should be recognised by recipients as assets at the earlier of receipt of the asset or the existence of an enforceable right to receive future delivery of the asset, or as reduced liabilities when the transferor waives its right to receive a future payment.

In our view, transfers without conditions should be recognised as revenue by recipients. Transfers with conditions should be recognised by recipients as a liability until such time as the conditions are met, at which point they should be recognised as revenue.

Recognised non-reciprocal transfers should be measured at their fair value or at their nominal value, provided that it can be measured reliably.

5.7.5 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.8 Accompanying financial and other information

(IAS 1)

Overview

- **An entity considers its particular legal or securities exchange listing requirements in assessing what information is included in addition to that required under IFRSs.**
- **Providing a financial and operational review is encouraged but not required.**

IAS 1.9, 6 In addition to disclosing additional information in the financial statements to achieve a fair presentation (see in particular 2.1), many entities provide additional information to accompany the financial statements. Accompanying information may be provided either voluntarily or because of regulatory requirements.

IAS 1.9 IFRSs are not based on a particular legal or listing framework; they also do not contain any requirements for management discussion and analysis as part of the financial statements or outside of the financial statements. However, an entity applying IFRSs may be subject to regulatory requirements. There may be national, regional or securities exchange requirements that specify financial and / or non-financial information that must be presented either within or outside of the financial statements.

Accompanying information generally is presented outside of the financial statements, for example, in a narrative section of the annual report, but may be presented within the financial statements if appropriate.

Factors that determine whether it is appropriate to present accompanying information within the financial statements include the nature and purpose of the information, its relationship to IFRSs and whether it is intended to be covered by the auditor's report.

For example, it may be appropriate to provide accompanying information within the financial statements when it is intended to provide further explanation of specific financial statement items presented in accordance with IFRSs.

Alternatively, it may be inappropriate to provide accompanying information within the financial statements when it is presented in a manner that could lead a user to conclude it is in accordance with IFRSs when in fact it is not. For example, when an unlisted entity wishes to provide segment information (see 5.2), but is unable to obtain all of the required information, or wishes to disclose only limited segment information, in our view that segment information should be presented outside of the financial statements (e.g., as part of the directors' report). The entity could indicate that it has prepared the information in accordance with IAS 14, if appropriate, except that certain disclosures (which should be identified) have been omitted.

When accompanying information is intended to be unaudited, it is important that it be presented in a manner that clearly differentiates it from the audited information and that avoids any cross-referencing from audited information. The most effective way to achieve this usually is to present the information outside of the audited financial statements.

Accompanying information normally will be of interest to a wide range of users, but often is aimed at the needs of investors. In our view, an entity should apply the guidance in the Framework (see 1.2) to ensure that the accompanying information is relevant, reliable, comparable, complete and free from bias.

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5.8.1 General non-financial information

The primary purpose of any accompanying discussion and analysis normally is to assist users of the financial statements in assessing the current and future performance of the entity by setting out management's analysis of the business.

IAS 1.9

IFRSs note that many entities present, outside the financial statements, a financial review by management that describes and explains the main features of the entity's financial performance and position, and the principal uncertainties it faces.

Such additional information often is presented in the directors' report, chairman's report or other accompanying information and may include a review of:

- the main factors and influences affecting the entity's performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and its policy for investment to maintain and enhance performance, including its dividend policy;
- the entity's sources of funding, the policy on gearing (borrowing levels) and its risk management policies; and
- the entity's strengths and resources whose value is not reflected in the balance sheet under IFRSs (e.g., internally generated goodwill).

IAS 1.10

Entities also are encouraged to present additional statements such as environmental reports and value added statements if management believes that this additional information will assist users in making investment decisions.

An entity may provide more information than that suggested in IAS 1 (and summarised above). Examples of specific disclosure that often is provided in the directors' report or other accompanying information include:

- General:
  - principal activities of the reporting entity
  - mission statement and values
  - list of directors and officers
  - chairman's and chief executive officer's statements
- Business review:
  - operating results for the period
  - activities and development in each segment
  - market and product development, including research activities and competitor information
  - expectations regarding future developments
  - acquisitions and disposals of businesses
  - general description of the risks facing the reporting entity
- Financial review:
  - capital structure and financial position
  - stock exchange information, including share prices, dividends, and shareholder information and profiles
  - tables of financial data and key figures for periods in addition to those covered in the financial statements and comparative periods (e.g., for the last five or 10 years)
  - information about risk management and sensitivity of key assumptions (in addition to that required by IFRSs, see 5.6), for example, value at risk
- Other items:
  - directors' interests and management philosophy
  - events subsequent to the balance sheet date
  - agenda for the annual general meeting
  - information technology policies and significant investments
  - specific disclosures required by laws and regulations

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An entity may wish to discuss some of the above areas on a segment basis.

IAS 1.126(a), (b) Disclosure of the country of incorporation of the entity, address of the registered office (or principal place of business), description of the nature of the entity's operations and its principal activities often is provided outside the financial statements. Otherwise, the entity must provide these disclosures in the financial statements.

5.8.2 Corporate governance

IFRSs do not provide guidance on disclosure of corporate governance information. Often a local legal or securities exchange requirement specifies what corporate governance information should be disclosed.

Examples of corporate governance disclosures include:

- composition of the board of directors, including their responsibilities, criteria for election, term of office and frequency of, and attendance at, board meetings
- if there is a supervisory board, the names of members of this board and a report of the supervisory board may be included in the annual report
- names and responsibilities of the chief executive officer and president
- identification and responsibilities of executive and other management groups
- identification, composition and responsibilities of various committees and sub-boards, for example, advisory board, personnel committee, audit committee, nomination committee and other entity-specific committees such as a research and development committee or environmental committee
- details of the remuneration of individual directors, including share or other incentive schemes (see 4.5, 4.5A and 5.5)
- insider trading policies and practices
- risk management disclosures, including board accountability and systems of control
- sustainability disclosures including social, ethical, safety, health and environmental policies and practices

5.8.3 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.9 Interim financial reporting

(IAS 34)

Overview

- **Interim financial statements contain either a complete or condensed set of financial statements for a period shorter than a financial year.**
- **Condensed interim financial statements contain, as a minimum, condensed balance sheets, condensed income statements, condensed cash flow statements, condensed statements of changes in equity and selected explanatory notes.**
- **Items, other than income tax, generally are recognised and measured as if the interim period were a discrete period.**
- **Income tax expense for an interim period is based on an estimated average annual effective income tax rate.**
- **Normally, the accounting policies applied in the interim financial statements are those that will be applied in the next annual financial statements.**

5.9.1 Scope

IAS 34.1 IFRSs do not require presentation of interim financial statements. Publicly traded entities are encouraged to provide interim financial statements at least for the first six months of their financial year. Regulators may require interim financial statements to be prepared, and also may specify the frequency of preparation (e.g., quarterly or half yearly). An entity is not required to prepare interim financial statements in accordance with IAS 34 in order for its annual financial statements to comply with IFRSs.

IAS 34.1-3, 7, 19 If an entity prepares interim financial statements, IAS 34 may be applied in their preparation and presentation. If an entity wishes to state compliance with IFRSs in its interim financial statements, IAS 34 must be applied. The interim financial statements should state that they comply with IAS 34, if this is the case. IAS 34 permits the presentation of condensed interim financial statements. An entity also may prepare a full set of financial statements covering the interim period.

IAS 1.3, 13-41 IAS 34 provides guidance on the structure and content of condensed interim financial statements. The overall considerations for preparing financial statements in IAS 1 also are applicable to condensed interim financial statements. These include guidance on fair presentation and compliance with IFRSs, going concern, accrual basis of accounting, consistency of presentation, materiality and aggregation, offsetting and comparative information.

IAS 34.9 Sometimes a complete set of financial statements is published for an interim period prepared in accordance with IFRSs. The form and content of those financial statements must comply with the requirements of IAS 1 (see 2.1).

IAS 34.7 The recognition and measurement guidance in IAS 34 also must be applied when a full set of IFRS financial statements are prepared in accordance with IFRSs for an interim period.

IAS 34.14 Generally, the interim financial statements are prepared on a consolidated basis if the most recent annual financial statements were prepared on that basis. In our view, this approach is not required if an entity disposes of its last subsidiary during the interim reporting period. In these cases, consolidated financial statements are no longer required, as the entity no longer is a parent at the reporting date (see 2.5). In our view, the interim financial statements, including the comparatives,

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should be presented for the parent only and identified as such. Disclosure of the previously reported consolidated information as supplementary information may be useful.

5.9.2 Form and content

IAS 34.10, 15 IAS 34 permits interim financial statements to be prepared in a condensed format, omitting most disclosures that are required to comply with IFRSs when publishing a full set of IFRS financial statements. This condensation and omission of disclosures is permitted assuming that the financial statement user will have access to the most recent annual financial statements. The interim financial statements therefore should focus on changes since the last annual financial statements.

IAS 34.8, 20 Interim financial statements must include at least:

- condensed balance sheets, at the end of the current interim period and at the end of the immediately preceding financial year;
- condensed income statements, for the current interim period and cumulatively for the year to date, and for the comparable interim period (current and cumulative) of the immediately preceding financial year;
- condensed statements of changes in equity, cumulatively for the current year to date and for the comparable year-to-date period of the immediately preceding financial year;
- condensed cash flow statements, cumulatively for the current year to date and for the comparable year-to-date period of the immediately preceding financial year; and
- certain explanatory notes.

IAS 34.10, 11 The above statements must include, as a minimum, each of the headings and sub-totals that were included in the most recent annual financial statements. Basic and diluted EPS are presented on the face of the income statement (see 5.3).

IFRSs do not prescribe the structure and appearance of interim financial statements. In our view, it is preferable to present the interim information (including the comparative information) in one section in an interim report. However, there is nothing that prevents presentation or disclosure in another manner, as may be prescribed by local regulatory requirements or considering other factors.

Seasonal businesses

IAS 34.21 IAS 34 encourages entities with highly seasonal activities to supplement the required financial statements with information for the 12 month period ending on the interim reporting date, as well as comparatives.

There is no guidance on what additional information might be provided, and in our view such information may be limited to the information that is affected by seasonality, for example, revenue and gross margin.

Explanatory notes

IAS 34.15 Entities are not required to repeat or provide insignificant updates to information already reported in the most recent annual financial statements.

The entity provides explanatory notes, including a description of any transactions and events that may be material to an understanding of the current interim period, and therefore should be disclosed. Some items may be considered material because of their nature rather than their size (e.g., unusual and exceptional items (see 4.8)).

For example, considering the increasing importance of corporate governance issues, in our view it is preferable that related party transactions be disclosed in the interim financial statements in all circumstances, except when clearly immaterial. Even if the related party transactions are not material by virtue of their size, we encourage highlighting the existence of these transactions

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together with a reference to the relevant disclosure in the annual financial statements. If related party transactions also are material in terms of size, more extensive disclosure may be appropriate.

Comparative information

IAS 34.20, 1.36 When compliance with IAS 34 is claimed, all requirements of the standard should be complied with. This includes providing comparative interim information for both quantitative and, when appropriate, narrative information (see 2.1).

For example, in an initial public offering, half yearly interim financial statements may be presented in addition to two or three full years of annual financial statements. In our view, if the interim financial statements claim compliance with IFRSs, presentation of the comparative interim period also is required.

5.9.3 Recognition and measurement

Generally IAS 34 requires items to be recognised and measured as if the interim period were a discrete stand-alone period. However, the tax charge is based on the expected weighted average effective rate for the full year (see *Income tax expense* below).

IAS 34.23 Determination of materiality should be made in relation to the interim period financial information, rather than in relation to the prior or current annual period.

IAS 34.37, 39 The conditions for recognising expenses and provisions are the same for interim financial statements as for annual financial statements. Therefore, losses, expenses and income are recognised as incurred and may not be anticipated (see 3.11). Similarly, costs and income that are incurred or earned unevenly during the financial year are anticipated or deferred at an interim balance sheet date if, and only if, it also is appropriate to anticipate or defer that type of cost or income at the end of the financial year.

Inventory losses and manufacturing variances

IAS 34.B28 Losses on inventories and interim period manufacturing cost variances are recognised using the same procedures as would be used at the financial year end reporting date. Therefore, they cannot be deferred on the basis that they are expected to be restored or absorbed by the end of the year.

Volume rebates and discounts

IAS 34.B23 Volume rebates and discounts often are granted by a supplier to a purchaser on a "stepped" basis, and calculated based on the volume or value of purchases during a certain period, for example, a full year. Both buyers and sellers should anticipate volume rebates and other contractual price adjustments if it is probable that these will be earned.

As an example, an entity purchases goods and receives the following rebates, based on purchases during a calendar year, which also is the entity's financial year:

- up to 1,000 units – rebate of one per cent of the purchase price
- up to 2,000 units – rebate of two per cent of the purchase price
- more than 2,000 units – rebate of three per cent of the purchase price

Usually the majority of purchases take place in the fourth quarter. The entity prepares quarterly interim reports. After the first quarter, the entity has purchased 300 units. The entity has concluded that it is probable that it will purchase 3,500 units for the full year, reflecting its past experience and current year budgets.

In our view, the percentage used to determine the rebate to be recognised by both the seller and the purchaser should reflect the expected sales volume for the full year. Therefore, the entity applies a

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rebate percentage of three per cent to measure the cost of purchases during the first quarter, based on expected purchases of 3,500 units for the full period.

When an entity cannot make a reliable estimate of total expected annual purchases, a percentage based on the volume purchased at the interim date is applied.

Discretionary rebates and discounts are not anticipated.

Seasonal results

IAS 34.37, 38

Revenue that is received seasonally or occasionally within a financial year is not anticipated or deferred, but is recognised when it is earned.

As an example, an entity makes and sells printed directories. Income is earned primarily from advertisements placed in the directories and is recognised as revenue when the directories are delivered to the users (see 4.2).

In our view, revenue may not be deferred or anticipated at any interim reporting date, and therefore cannot be spread over the full year reporting period.

Any related expenses, such as costs to produce the directories, are capitalised to the extent that IAS 2 permits (see 3.7) until the revenue and the related cost of sales is recognised. Expenses that cannot be capitalised as part of inventory must be expensed as incurred.

Amortisation charges

Intangibles often are amortised on a straight-line basis. In our view, recognition of amortisation on a straight-line basis means evenly throughout the year. An entity with seasonal revenue does not recognise a time-based amortisation charge only in the period during which seasonal revenue is earned.

In our view, this treatment also is applied to other assets that are depreciated on a straight-line basis, for example, items of property, plant and equipment.

Major planned periodic maintenance or overhauls

IAS 34.B2

Costs of planned or periodic maintenance or overhauls are not anticipated for interim reporting purposes unless the requirements to recognise a provision are met at the reporting date (see 3.11). Similarly, other planned or budgeted (but not yet incurred) costs, for example, employee training costs, also are not anticipated.

As an example, B produces canned food using fresh vegetables. B's financial reporting date is 30 June. Production takes place from 1 July to 31 December and most workers are temporary. From 1 January to 30 June, the plant is closed and maintenance work is performed.

Directs costs (labour) are incurred largely over the first six month period, but other significant costs are incurred during the second six month period, for example cleaning and maintenance of the factory. Depreciation of the machinery and plant also are direct costs of production.

- Maintenance and repair costs are recognised as incurred. B does not recognise a provision for the costs to be incurred during the second half of the year at the end of the first interim period. However, B should consider whether these costs either are capitalised as part of the plant as they are incurred or should be considered to be a separately recognised component of the plant (see 3.2).
- Depreciation of the operating assets should be allocated on a systematic basis that reflects the pattern in which the asset is used in production. In our view, a unit of production method may be appropriate for operating assets (such as plant and production equipment). If so, then the annual depreciation charges relating to these assets would be spread over the first six months

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of the year. The planned maintenance shut down for the second six months means that a straight-line time-based charge over the 12 months is unlikely to be appropriate for such assets.

Assets measured at fair value or revaluation

IAS 34.C7 The carrying value of assets that are measured at fair value, for example, investment property, should be determined at the interim reporting date. The fair value assessment may involve a higher degree of estimation than is used for the annual financial statements. In practice, external valuers are not used at interim reporting dates, and in our view, extrapolations based upon the previous annual reporting date balance may be appropriate for interim financial statements.

When the cost model is applied for investment property, disclosure of the fair value of investment property still is required in full IFRS financial statements. In our view, if the fair values have changed significantly from those that were disclosed at the previous annual reporting date, the updated values should be disclosed in the condensed interim financial statements together with additional disclosure necessary to explain the changes. If there are no significant changes from the fair values presented in the most recent annual financial statements, we believe that those fair values should be disclosed in the interim financial statements together with a reference to the relevant note in the annual financial statements.

Employee benefits

IAS 34.B9, C4 The interim balance sheet position generally is determined by adjusting the opening balance sheet for the current service cost, interest cost, expected return on assets, amortisation of actuarial gains and losses, and contributions to the plan and generally does not involve obtaining an updated actuarial valuation.

However, material changes to the plan such as a curtailment or settlement or in market conditions should be adjusted for in the interim calculation. In our view, if there is a significant change in the plan, or an event such as significant investment losses occur, we expect the actuarial valuation would be updated at the interim reporting date.

IAS 19.110 In addition, IAS 19 specifically requires remeasurement of plan assets and obligations at the point in time that a curtailment or settlement is recognised.

In our view, when it is necessary to update the actuarial valuation at the interim reporting date and internal expertise is not available to do so, an actuary should perform the updated valuation. When there are significant changes to the plan, the appropriateness of significant estimates also should be evaluated at the interim reporting date.

Income tax expense

IAS 34.30(c), B12-16 The income tax expense recognised in each interim period is based on the best estimate of the weighted average annual income tax rate expected for the full year applied to the pre-tax income of the interim period.

This effective rate should reflect enacted or substantially enacted changes in tax rates that are expected to take effect later in the year. Amounts accrued in one interim period may need to be adjusted in a subsequent interim period if the estimate of the annual income tax changes (see *Changes in estimates* below). The income tax expense for an interim period comprises both current tax and deferred tax.

IAS 34.B19 Anticipated tax benefits from tax credits generally are reflected in computing the estimated annual effective tax rate when the credits are granted and calculated on an annual basis. However, when the credits relate to a one-off event, they are recognised in computing the income tax expense in the interim period in which the event occurs.

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IAS 34.B14 If different income tax rates apply to different categories of income, for example, capital gains, or to different tax jurisdictions, a separate rate is applied to each category in the interim period, to the extent that it is practicable. However, a weighted average rate across jurisdictions and income categories may be used if it is a reasonable approximation of the effect of using more specific rates.

As an example, A and B, two subsidiaries within a group, have different effective tax rates. While B's activities are not seasonal, A has seasonal activities. The expected results for the full year are as follows:

	A	*B*	*Total group*	
Pre-tax profit (loss) – first six months	(100)	60	(40)	
Pre-tax profit – second six months	200	60	260	
Total profit before tax	**100**	**120**	**220**	
Expected tax expense	(33)	(12)	(45)	
Effective tax rate	**33%**	**10%**	**20.5%**	(45/220)

In our view, it is not appropriate to use an annual consolidated effective tax rate of 20.5 per cent to estimate the interim period tax expense. This is because it is unlikely that this weighted average rate will be a reasonable approximation of the rate for each component of the group, due to the impact of the seasonality of A's operations combined with the difference in effective rates.

The effective rate for each subsidiary should be applied to interim profits to determine the interim income tax expense for the group, as follows:

First six months	*A*	*B*	*Total group*	
Pre-tax profit (loss)	(100)	60	(40)	
Income tax benefit (expense)	33	(6)	27	
Effective tax rate ((benefit) expense)	**(33)%**	**10%**	**(67.5)%**	(27/40)

Second six months	*A*	*B*	*Total group*	
Pre-tax profit	200	60	260	
Income tax expense	(66)	(6)	(72)	
Effective tax rate (expense)	**33%**	**10%**	**27.7%**	(72/260)

There may be cases when a reliable estimate of the annual effective tax rate cannot be made. That situation may arise, for example, when relatively small changes in estimated pre-tax accounting income would produce a large change in the estimated annual effective rate. In our view, in cases when a reliable estimate of the annual effective rate cannot be made, the actual effective rate based on a year-to-date actual tax calculation may represent the best estimate of the annual effective tax rate.

Permanent differences

The average annual effective tax rate is based on the estimated pre-tax profit (loss) for the year. It is unclear whether the estimated pre-tax profit (loss) for the year should be adjusted to exclude non-tax deductible items such as brand amortisation.

The following example illustrates this issue:

Group X is required to prepare quarterly interim financial statements in accordance with IFRSs. To estimate the amount of its income tax expense for the first quarter of 2003, Group X has prepared annual projections of income and tax.

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Group X has made the following assumptions:

- the average enacted tax rate applicable to the group is 40 per cent;
- no temporary differences will exist at the end of the financial year; and
- the only permanent difference at the end of the year will be brand amortisation, which is not deductible for tax purposes.

Estimation of the average effective tax rate

	End of 2004
Projected annual profit before tax and brand amortisation	1,200
Projected annual brand amortisation	(600)
Projected annual pre-tax profit	600
Projected annual income tax expense (1,200 x 40 per cent)	480

There are two different approaches to estimate both the average annual effective income tax rate and the income tax expense for the interim periods.

	Tax rate
Method 1: (480/1,200)	40%
Method 2: (480/600)	80%

In method 1, Group X calculates the average annual effective tax rate by adjusting the reported income for the effect of the brand amortisation that is not tax deductible.

Method 2 does not adjust for the difference relating to non-tax deductible brand amortisation and the estimated average annual effective income tax rate increases to 80 per cent for the current year. This expected annual effective tax rate of 80 per cent differs from the average enacted tax rate due to the significance of the brand amortisation.

The following illustrates the impact of applying either method 1 or 2 in the interim financial statements:

Income tax expense estimation

	Q1	*Q2*	*Q3*	*Q4*	*2004*
Profit before tax and amortisation (a)	50	350	400	400	1,200
Amortisation of brand	(150)	(150)	(150)	(150)	(600)
Pre-tax profit (loss) (b)	(100)	200	250	250	600
Income tax expense – Method 1: (a) x 40 per cent	(20)	(140)	(160)	(160)	(480)
Effective tax rate					80%
Income tax benefit (expense) – Method 2: (b) x 80 per cent	80	(160)	(200)	(200)	(480)
Effective tax rate					80%

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In our view, Group X may make an accounting policy election, which should be applied consistently, to calculate the annual effective tax rate.

- Our preferred approach would be to use the estimated pre-tax income (loss) for the year without adjustment to exclude non-tax deductible items such as brand amortisation. In this example, an effective tax rate of 80 per cent is applied to the pre-tax accounting profit during each interim period (method 2).
- However, we also would accept an approach under which the effective income tax rate is calculated based on the estimated *taxable* income for the interim period. Under this approach the accounting income is adjusted for permanent differences, including non-tax deductible brand amortisation. In this example, an effective tax rate of 40 per cent is applied to the accounting profit *after* the adjustment for the effects of the brand (method 1). This approach treats identifiable non-tax deductible costs (or non-tax deductible income), such as brand amortisation, in a similar way to different categories of income (e.g., capital gains) to which a different tax rate is applied. In our view, this approach would be appropriate only when the amounts are significant, could be identified separately, different tax rates are applied to *each* separate category of income and an entity applies the same level of analysis to identify, in each tax jurisdiction, items taxed at both higher and lower rates.

Tax losses

Tax losses may be carried forward from previous reporting periods or may be created during an interim period and reverse in subsequent interim periods.

IAS 34.B20-22

The benefit of a tax loss is recognised in the interim period in which it occurs. The general criteria for recognition of a deferred tax asset is applied at each interim reporting date (see 3.12). The entity will assess the probability of generating enough taxable profits in future periods to utilise the tax benefit.

The effect of any tax loss is considered in determining the average effective tax rate for the year. For example, in its first quarter B incurs a tax loss as a result of poor trading conditions, but anticipates making a profit for the year and paying tax for the full year. B estimates its tax expense for the year taking into account the losses in the first period and utilisation thereof in later interim periods. The effective tax rate is applied to the pre-tax loss and a deferred tax asset recognised at the end of the first quarter. The reversal of tax losses within a year is illustrated in method 2 in the example of *permanent differences* above.

Current and deferred tax

Although IAS 34 provides guidance on how the income tax expense should be determined, it does not specify how the total amount should be split between current and deferred tax. An example of an appropriate method may be to split current and deferred tax based on the relative proportions expected at the end of the financial year. In practice, most entities do not show this split.

As a result of calculating income tax expense (and consequently deferred taxes) by applying the effective tax rate to the profit for the interim period, the impact of temporary differences that do not impact the income statement (e.g., temporary differences on revaluation of fixed assets) would not be reflected. In our view, when these are material, deferred tax also must be calculated for those items recognised directly in equity in order to measure that portion of the deferred tax asset or liability.

Changes in estimates

IAS 34.35, 41

While measurements in both annual and interim financial statements often are based on reasonable estimates, the preparation of interim financial statements generally will require a greater use of estimation than annual financial statements. Changes to accounting estimates are applied to the current and future periods and do not involve the restatement of results for either the prior year or prior interim periods in the current financial year (see 2.8).

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For example, D prepares quarterly interim financial statements. The carrying value of an asset is 100,000 and the useful life initially is estimated to be 10 years. The resulting depreciation expense is 10,000 for the year and is 2,500 for the first quarter. Subsequently, there is a change to the estimated useful life of the asset, which, at the beginning of the second quarter, is revised to be five years from that date. The depreciable amount as at the end of the first quarter is 97,500 and, in our view, is depreciated over the remaining useful life of five years because the change in estimate is applied prospectively. Depreciation of 4,875 will be recognised for each quarter (97,500/20 quarters) over the remaining useful life of the asset.

As another example, P recognises an impairment loss in its interim financial statement for the first quarter. The asset is sold during a subsequent interim period and a gain is realised.

IAS 34.28 IFRS require that the measurement of annual results are not affected by the frequency of an entity's financial reporting (i.e., annual, half-yearly or quarterly). This may mean that estimates, for example of recoverable amount, are revised in a subsequent interim period on a year-to-date basis. However, in our view, separate transactions and events should be accounted for as such under IFRSs. In the above example, the impairment loss should not be reclassified and offset against the gain on disposal merely because they occurred in two interim periods of a single year. In addition, the gain does not lead automatically to the reversal of the earlier impairment loss. Instead, each of the impairment loss, any possible reversal of that loss and the gain on disposal are dealt with separately, in accordance with individual requirements. However, recognition of a gain shortly after a loss may be an indicator that either the event giving rise to the impairment has reversed or that the estimates used should be reconsidered and, if necessary, revised.

IAS 34.26 Any significant change in estimates made during the final interim period should be disclosed in the annual financial statements, unless separate interim financial statements are published for this period.

5.9.4 Accounting policies

IAS 34.28 The accounting policies followed in the interim report generally will be the same as those applied in previous annual financial statements, except for changes in accounting policies made during the current financial year.

IAS 34.43 Any change in accounting policy on adoption of a new or revised standard is accounted for in accordance with the transitional requirements specified in the relevant IFRSs if such guidance is provided. Otherwise, the change in accounting policy is accounted for in accordance with IAS 8 (see 2.8).

Any new standards should be applied to all interim periods within the annual period in which the new standards are first adopted unless the transitional provisions of a standard permit or require different transition. For example, if an entity has a balance sheet date of 31 December 2005, it should apply any new standards that are effective for periods commencing on or after 1 January 2005 in its interim financial statements at 31 March 2005, 30 June 2005 and 30 September 2005. The entity should not apply earlier versions of the standards in the interim financial statements and then change to the new standards for the annual financial statements.

Changes in accounting policy adopted after the first interim period normally are presented by restating the financial statements for prior interim periods of the current financial year and comparative interim periods presented. This may occur, for example, if a new or revised standard is published during the year and the entity early adopts the new standard.

The accounting policies to be applied by a first-time adopter of IFRSs are considered in section 6.

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5.9.5 First-time adoption of IFRSs

Additional disclosures are required when the first-time adoption of IFRSs occurs in interim financial statements. This issue is considered further in section 6.

5.9.6 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted.

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5.10 Insurance contracts

(IFRS 4)

Overview

- **The standard is effective from 1 January 2005, with early application encouraged.**
- **IFRS 4 permits, in most cases, an entity that issues insurance contracts to continue its existing accounting policies with respect to insurance contracts.**
- **An insurance contract is a contract that transfers significant insurance risk.**
- **Any financial instrument which does not meet the definition of an insurance contract (including investments held to back insurance liabilities) will be accounted for under the general recognition and measurement requirements for financial instruments in IFRSs.**
- **Changes in existing accounting policies for insurance contracts are permitted if the new policy, or a combination of new policies, results in information that is more relevant or reliable without reducing either relevance or reliability.**
- **IFRS 4 permits financial instruments that include discretionary participation features to be accounted for as insurance contracts although these are subject to the disclosure requirements in IAS 32.**
- **In some cases a deposit element is required to be unbundled from an insurance contract.**
- **Some derivatives embedded in insurance contracts must be separated from their host insurance contract and accounted for as they were stand-alone derivatives.**
- **Recognition of catastrophe and equalisation provisions is prohibited.**
- **A liability adequacy test is required to ensure that the measurement of an entity's insurance liabilities considers all expected contractual cash flows, using current estimates.**
- **The introduction of "shadow accounting" is permitted but not required.**
- **An expanded (gross) presentation is permitted for insurance contracts acquired in a business combination or portfolio transfer.**
- **Significant disclosures are required of the terms, conditions and risks related to insurance contracts.**

In March 2004, the IASB issued IFRS 4 *Insurance Contracts*. The standard is effective for annual accounting periods beginning on or after 1 January 2005. Early adoption is encouraged. The transitional requirements are discussed below (see 5.10.8).

5.10.1 Introduction

IFRS 4 represents the completion of the first phase of the IASB's project on accounting for insurance contracts. The IASB in developing IFRS 4, sought to minimise the amount of change required from current accounting policies and practices and to avoid changes that may be reversed in the second phase of the IASB's insurance project. Therefore, IFRS 4 permits entities to continue most of their current accounting policies for insurance contracts but places restrictions on the introduction of new policies.

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5.10.2 Scope

IFRS 4.2, 3 IFRS 4 applies to *insurance contracts* (including reinsurance contracts) that an entity issues and reinsurance contracts that it holds (i.e., for the contractual rights and obligations arising from these contracts). It does not address other aspects of accounting by insurers, for example, accounting for financial instruments, which are in the scope of IAS 39 (see 3.6) or other assets and liabilities of insurance entities. It also does not address accounting by policyholders, other than holders of reinsurance contracts.

IFRS 4.2 The scope of IFRS 4 also includes *financial instruments with a discretionary participation feature* that an entity issues.

IFRS 4.4, 4.B18, B19 IFRS 4 focuses on types of contracts rather than types of entities. Therefore, IFRS 4 applies to both entities regulated as insurance entities and all other entities. Some contracts that may meet the definition of insurance contracts are excluded from the scope of IFRS 4, such as product warranties issued directly by a manufacturer or retailer, employers' assets and liabilities under employee benefit plans, some financial guarantees and contingent consideration payable or receivable in a business combination. Rights and obligations excluded from IFRS 4 may be dealt with specifically in another standard for example, assets and liabilities under employee benefit plans, which are covered by IAS 19 (see 4.4), financial instruments including certain financial guarantees, which are covered by IAS 39 (see 3.6) and provisions, contingent liabilities and contingent assets which are covered by IAS 37 (see 3.11 and 3.13). The treatment of other rights and obligations should be considered under the hierarchy (see 1.1).

Definition of an insurance contract

IFRS 4.A An insurance contract is a contract under which the insurer accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. This specified uncertain future event is known as the insured event.

IFRS 4.B2 Entities applying IFRSs must determine which contracts are insurance contracts and therefore within the scope of IFRS 4. Some guidance is provided to clarify the above definition. One central characteristic is the *specified uncertain future event*. Uncertainty (or risk) is the essence of an insurance contract. Therefore, there must be uncertainty at the inception of an insurance contract regarding whether an insured event will occur, when it will occur, or how much the insurer will need to pay if it occurs.

IFRS 4.A The uncertain future event that is covered by an insurance contract creates "insurance risk". Insurance risk is any risk, other than financial risk, transferred from the holder to the issuer of a contract. Financial risk is the risk of a possible future change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided, in the case of a non-financial variable, that is not specific to a party to the contract. Risks such as death, illness, disability, loss of property due to damage, theft, etc. are each an insurance risk because they are specific to a party to the contract.

Credit default risk also is a form of insurance risk, as the risk of loss is specific to the policyholder and not market-price based. This area of IFRSs may be subject to future developments (see 5.10.9).

IFRS 4.B15, B16 Lapse or persistency risk (i.e., the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) or expense risk (i.e., the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in costs associated with insured events) is not insurance risk because it does not adversely affect the counterparty. However, if the issuer of a contract exposed to lapse, persistency or expense risk mitigates that risk by using a second contract to transfer all or part of that risk to another party, the second contract exposes that other party to significant insurance risk and is therefore an insurance

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contract. However, the transferor is the policyholder of that second contract and therefore the contract is not subject to IFRS 4 from the policyholder's perspective.

IFRS 4.B22-B28 A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract and therefore the contract would be accounted for as a financial instrument (see 3.6). Insurance risk is significant when there is at least one scenario that has commercial substance in which the insurer would suffer a significant loss. A loss event has commercial substance if it has a discernible effect on the economics of the transaction, so that the insurer would be required to pay additional benefits to the policyholder beyond those that would be paid if the insured event does not occur. It does not matter that the insured event is extremely unlikely or even if the expected present value of contingent cash flows is a small proportion of the expected present value of all of the remaining contractual cash flows. The additional benefits referred to above can include a requirement to pay a benefit earlier (e.g., upon death) than if the policyholder survives for a longer period.

IFRS 4.B25 Insurance risk is assessed in relation to the individual contract and without considering portfolio effects, and so insurance risk may be significant even if material losses are not expected in a portfolio of contracts. However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within this book.

IFRS 4.B29, 4.IG example 1.7 Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time. In these cases, the contract is not considered an insurance contract until the risk transfer occurs. For example, a contract may provide a specified investment return and also specify that the policyholder will receive, or can elect to receive, a life-contingent annuity at rates determined by the insurer when the annuity begins. Such a contract is not an insurance contract at the outset. To be an insurance contract at the outset, it is necessary that the annuity rate or the determination basis is already fixed. Once a contract has qualified as an insurance contract it remains an insurance contract until all rights and obligations are extinguished or expired.

Deposit components and embedded derivatives in insurance contracts

IFRS 4.10 Some insurance contracts contain a *deposit component*, which is a component that would, if it were a stand-alone instrument, be a financial instrument (see 3.6). The deposit component is required to be *unbundled* and accounted for as a financial instrument if the rights or obligations under that component otherwise would not be recognised under the insurer's accounting policies. To be unbundled the deposit component also must be able to be measured separately. For example, certain reinsurance contracts specify that any compensation received from the reinsurer for losses will be reimbursed to the reinsurer by increases in future reinsurance premiums. Because the repayment is not contingent, the obligation arises from a deposit component and the deposit obligation must be unbundled and accounted for separately as a financial liability, provided that it can be measured separately and that the accounting policies otherwise would not recognise the repayment obligation.

If a deposit component can be measured separately but the entity's accounting policies require it to recognise all obligations and rights arising from the deposit component unbundling is permitted.

Unbundling is prohibited if an insurer cannot measure the deposit component separately. The deposit component then is accounted for as an integral part of the insurance contract.

IFRS 4.IG example 2 Components of insurance contracts that meet the definition of a derivative are within the scope of IAS 39 and are therefore subject to the general requirements for embedded derivatives.

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IAS 39.10, 11 An *embedded derivative* is separated from its host contract and measured at fair value, recognising the changes in the fair value in profit or loss, if, and only if, the following criteria are met:

- its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract;
- it meets the definition of a derivative; and
- the combined instrument is not measured at fair value with fair value changes recognised in profit or loss.

IFRS 4.7-9 IFRS 4 provides two significant exemptions to the general requirements of IFRSs to separate embedded derivatives. These exemptions are for:

- components that do not meet the definition of a derivative (e.g., since they are insurance contracts); and
- surrender options with fixed terms.

As insurance contracts are not within the scope of IAS 39, the requirements in that standard to separate embedded derivatives (see 3.6) are not applicable to insurance contracts embedded in a host contract. A component meeting the definition of an insurance contract does not need to be separated from its host contract. For example, an option to take a life-contingent annuity contract would not be separated from a host insurance contract.

An insurer is not required to separate a fixed-price surrender option from a host insurance liability, or a surrender option based on a fixed amount and an interest rate. Even though the surrender value may be viewed as a deposit component, IFRS 4 does not require unbundling of a contract if all obligations arising under the deposit component are recognised.

IAS 39.AG33 Since liabilities under unit-linked contracts generally are measured at their current unit values, there is no need to separate a host deposit contract and an embedded derivative for such contracts.

5.10.3 Recognition and measurement

Accounting policies for insurance contracts

IFRS 4.13 In order to allow an insurer to continue using its existing accounting practices for insurance contracts as far as possible, IFRS 4 exempts an entity from applying certain portions of the "GAAP hierarchy" (see 1.1) to insurance contracts. Without these changes, an insurer adopting IFRSs would have needed to assess whether its accounting policies for insurance contracts comply with the IFRS GAAP hierarchy requirements, in particular the Framework and all other IFRSs.

IFRS 4.25 IFRS 4 also permits an insurer to continue some existing practices but prohibits their introduction. For example, under IFRS 4 an entity is not required to eliminate excessive prudence in accounting for insurance contracts nor, on consolidation, to apply consistent accounting policies to insurance contracts held by each entity within a group. There also is no requirement to use discounting in the measurement of insurance liabilities. However, these policies may not be adopted if they were not used when an entity adopts IFRS 4. For example, an entity that did not use excessive prudence may not adopt a policy of doing so on or after adopting IFRS 4.

IFRS 4.14 Nevertheless, the impact of the exemption from portions of the hierarchy in IAS 8 is limited by five specific requirements. An insurer *shall not*:

- recognise as a liability any provisions for possible future claims under insurance contracts if those contracts are not in existence at the balance sheet date, such as catastrophe and equalisation provisions; or

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- offset reinsurance assets against the related insurance liabilities or offset reinsurance income and expenses against expenses or income from the related insurance contracts.

However, an insurer *must*:

- derecognise an insurance liability only when the obligation specified in the contract is discharged, cancelled or expires;
- consider whether its reinsurance assets are impaired; and
- carry out a liability adequacy test.

Liability adequacy test

IFRS 4.15 An insurer must assess at each balance sheet date whether its recognised insurance liabilities (less related deferred acquisition costs and related intangible assets) are adequate, using current estimates of future cash flows under the insurance contracts. Any adjustment is recognised in profit or loss.

IFRS 4.16-18 At a minimum, the assessment of the adequacy of the liability must consider current estimates of all contractual cash flows and of related cash flows such as claim handling costs, as well as cash flows resulting from embedded options and guarantees. If an insurer's existing accounting policies include an assessment that meets this requirement, no further test is required. If they do not, IAS 37 (see 3.11) must be applied to determine whether the recognised liabilities are adequate.

Reinsurance

IFRS 4 applies to all insurance contracts (including reinsurance contracts) that an entity issues and also to reinsurance contracts that an entity holds. Reinsurance contracts that an entity holds are an exception to the general scope of IFRS 4, which otherwise excludes accounting by policyholders. In the case of reinsurance contracts IFRS 4 also deals with the situation when the insurer – the cedant – is the policyholder. Therefore, there are separate requirements for the cedant's reinsurance assets as set out below.

IFRS 4.14(d), 4.BC106 The general requirements of IFRSs (see 3.1 and 5.6) prohibit offsetting of assets and liabilities as well as income and expenses. IFRS 4 prohibits offsetting of reinsurance assets against the related insurance liabilities and income or expenses from reinsurance contracts against expenses or income from the related insurance contracts. Even if offsetting is permitted or required under existing accounting policies, IFRS 4 requires a change in these respects.

IFRS 4.14(e), 4.BC107 The cedant must consider at each reporting date whether its reinsurance assets are impaired. The impairment test to be applied is based on the impairment test for financial assets (see 3.6). This general test is used to focus on credit risk (arising from the risk of default by the reinsurer and also from disputes over coverage) and not on matters arising from the measurement of the underlying direct insurance liabilities.

IFRS 4.20 A reinsurance asset is considered impaired if there is objective evidence that the cedant may not receive all amounts due to it under the terms of the contract, as a result of an event that occurred after initial recognition of the reinsurance asset. Additionally, the impact on the amounts that the cedant will receive from the reinsurer must be reliably measurable; otherwise recognition of impairment is prohibited.

Changes in accounting policies

IFRS 4.22 An entity is permitted to make changes in its accounting policies for insurance contracts as long as the change improves either the relevance or the reliability of its financial statements without reducing either.

The assessment of relevance and reliability is judged by the criteria in the hierarchy for selection of accounting policies (see 1.1) without the need to achieve full compliance with those criteria. This limit

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on voluntary changes in accounting policies applies both to changes made by an insurer that already applies IFRSs and to first-time adopters of IFRSs (see 6.1).

IFRS 4.24, 27, 30 An insurer is permitted, for example, to change a policy in order to:

- remeasure some insurance liabilities (but not necessarily all of them) to reflect changes in current market interest rates; at that time measurement can be changed to reflect other current estimates and assumptions as well;
- switch to a comprehensive, widely-used, investor-oriented model for insurance policy liabilities, even if this means a move towards recognising future investment margins, however such margins can be included only if that is done as part of an overall switch to an investor-oriented model and not as an isolated change; or
- apply "shadow accounting" to remeasure insurance liabilities to reflect recognised but unrealised gains and losses on related financial assets, classified as "available-for-sale" (see 3.6), in the same way that realised gains or losses are reflected. Under shadow accounting the effect of unrealised losses and gains on an insurance liability is recognised directly in equity consistent with the recognition of those unrealised gains and losses on the related financial assets.

In our view, an entity that is intending to move from its existing regulatory-based approach towards US GAAP for its insurance contract liabilities would satisfy the IFRS 4 requirements with respect to a comprehensive, widely-used, investor-oriented model for insurance contracts. However, entities applying US GAAP may do so only for their insurance contracts, as defined under IFRS 4, and cannot also apply other specialised industry accounting practices for items covered by other IFRSs.

5.10.4 Insurance contracts acquired in a business combination

IFRS 3.24 When an entity acquires another entity in a business combination, the acquirer must measure, at the date of exchange, the identifiable assets and liabilities acquired at fair value (see 2.6).

IFRS 4.31, IFRS 3.IE example 4 Therefore, an insurer must, at the acquisition date, measure at fair value the assets and liabilities arising under insurance contracts acquired in a business combination. Under IFRS 4, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- a liability measured in accordance with the insurer's existing accounting policies; and
- an intangible asset, representing the difference between the fair value of the acquired insurance contracts and the reported amount under the first component.

IFRS 4.BC147(b) For life insurance contracts this intangible asset often is described as the present value of in-force business (PVIF), present value of future profits (PVFP) or value of business acquired (VOBA). For a non-life insurance business a similar presentation may be used, for example, if acquired claim liabilities are not discounted.

IFRS 4.33, 4.BC149 The recognised acquired intangible asset is excluded from the scope of the general standard on intangibles (see 3.3). This was done to permit insurers to continue to use their existing method of amortisation. That measurement must be consistent with the measurement of the related insurance liability. In our view, this means that, unlike goodwill, this intangible asset generally is amortised over the estimated life of the contracts or a run-off period of insurance contract provisions. Since these intangible assets related to insurance liabilities are covered by the liability adequacy test (as to insurance liabilities related intangible assets), these assets also are excluded from the scope of the general standard on impairment, IAS 36 (see 3.9).

IFRS 4.32 An insurer acquiring a portfolio of insurance contracts (portfolio transfer), outside a business combination, also may use the expanded presentation described above.

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5.10.5 Contracts with discretionary participation features

IFRS 4.A A discretionary participation feature (DPF) is a contractual right of the investor or policyholder to receive, as a supplement to guaranteed benefits, additional benefits. These additional benefits generally are based on the performance of a specified pool of contracts, on the realised and / or unrealised investment returns on a designated pool of assets, or on the profit or loss of the entity. To fall within the definition of a DPF, the additional benefits need to be a significant portion of the total contractual benefits. The amount or timing of the participation benefit received by the policyholder needs to be contractually at the discretion of the issuer. Such contracts may be insurance contracts or investment contracts, and often are described as "participating" or "with profits" contracts.

IFRS 4.34 Any guaranteed amount, to which the policyholder has an unconditional right, must be classified as a liability by the entity issuing the policy. The amount payable under the DPF, if measured separately from the guaranteed amount, may be classified as a liability or as a separate component of equity. It may not be classified in an intermediate (mezzanine) category that is neither liability nor equity. The standard does not specify how the classification should be determined; however, it does require that the presentation adopted must be applied consistently.

IFRS 4.35 When a contract, classified as a financial instrument, contains a DPF, the contract falls into the scope of IFRS 4 and the guidance of IFRS 4 for insurance contracts also applies. If the entire DPF within the investment contract is classified as a liability, then the liability adequacy test must be applied to the whole contract. If some or all of the DPF is classified as equity, then the liability amount must include, at a minimum, the amount that would be recognised for the guaranteed element under IAS 39. However, if the recognised liability clearly is higher, then the issuer does not need to determine the amount that would result from applying IAS 39 to the guaranteed element.

IFRS 4.34(c) All premiums received may be recognised as revenue. However, the portion of profit or loss attributable to the equity component is presented as an allocation of profit or loss (in a manner similar to the presentation of minority interests), not as expense or income.

See 5.10.6 below regarding disclosure of financial instruments with a DPF.

5.10.6 Disclosures

IFRS 4.1 Disclosures are required that explain the amounts in the financial statements arising from insurance contracts. Disclosure of information that helps to understand amounts, timing and uncertainty of future cash flows arising from insurance contracts also is required.

IFRS 4.36, 37 An insurer is required to disclose:

- its accounting policies for insurance contracts;
- the amounts of the recognised assets, liabilities, income and expense arising from insurance contracts;
- how the most significant assumptions used to measure those amounts are determined (and if practicable, the assumptions themselves); and
- information about the effect of changes in assumptions. It also must disclose the reconciliations of changes in insurance liabilities, reinsurance assets and related deferred acquisition costs.

IFRS 4.38, 39 In addition to the above disclosure requirements, an insurer is required to disclose:

- its risk management objectives and policies for mitigating insurance risk;
- the sensitivity of profit or loss and equity to changes in insurance risk;
- concentrations of insurance risk (e.g., low-frequency, high-severity risks such as earthquakes or cyclical risks); and
- claims development information, covering all periods for which material claims (for which uncertainty remains) are outstanding, up to a maximum of 10 years.

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However, some transitional relief is available in respect of disclosure of prior year information (see 5.10.8).

IFRS 4.IG11-71 The implementation guidance to IFRS 4 suggests extensive *possible* disclosures. However, an insurer decides in the light of its circumstances how much detail has to be given to satisfy the disclosure requirements, how much emphasis it places on different aspects and how it aggregates information to portray the overall picture without combining information that has materially different characteristics.

IFRS 4.2, IAS 32.91A As financial instruments with a DPF, which are in the scope of IFRS 4, are nevertheless financial instruments, the disclosure requirements for financial instruments (see 5.6) still apply. IFRS 4 introduced a relaxation of the requirement to disclose fair values in such cases, if the fair value cannot be measured reliably.

5.10.7 Issues related to the application of IAS 39

Investment assets

With the exception of insurance assets, deferred acquisition costs related to insurance contracts, PVFP, and reinsurance assets, an insurer's accounting for its assets will follow other applicable standards within IFRSs. An insurer's financial assets will be accounted for as financial instruments (see 3.6). In our experience, a significant part of an insurer's investments are classified as available-for-sale and measured at fair value, generally with fair value changes recognised directly in equity. In some cases, fair value changes of investments will, or may, be recognised directly in profit or loss.

IFRS 4.45 An insurer is allowed to change its accounting policies for insurance liabilities, such as remeasuring the insurance liabilities to reflect current market interest rates and recognising the changes in insurance liabilities in profit or loss. To avoid artificial accounting mismatches an insurer (both a first-time adopter and an entity that already is applying IFRSs) is permitted to reclassify some or all of the financial assets as "at fair value through profit or loss", when it changes its accounting policies for insurance liabilities. As the reclassification is a change in accounting policy, IAS 8 applies (see 2.8).

This area of IFRSs may be subject to future developments (see 5.10.9).

Investments may be measured at amortised cost only if the strict requirements for held-to-maturity classification can be met or if they meet the definition of "loans and receivables" and are not classified as "available-for-sale" or "at fair value through profit or loss" (see 3.6). These requirements may be satisfied for some of an insurer's investment portfolio, but, in our view, they are unlikely to be satisfied for all.

Financial guarantee contracts

Financial guarantee contracts that meet the definition of an insurance contract are within the scope of IFRS 4. This area of IFRSs may be subject to future developments (see 5.10.9).

5.10.8 Transitional provisions

IFRS 4.41, 43 An entity already applying IFRSs must apply IFRS 4 retrospectively for annual periods beginning on or after 1 January 2005. One exception to this requirement is when it is impracticable to apply the liability adequacy test in the comparative periods.

IFRS 1.36A However, an exemption is provided from applying IFRS 4 to comparative information for a first-time adopter of IFRSs. This is consistent with the exemption for first-time adopters in respect of financial instruments (see section 6).

IFRS 4.40 An entity, whether a first-time adopter or an existing reporter under IFRSs, is not required to apply some of the disclosure requirements to its comparative periods, beginning before 1 January 2005.

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For example, actuarial assumptions, sensitivity analysis and insurance risk management policies are not required disclosures for an entity's comparative information for 2004 and earlier periods. Claims development disclosure also is not required in respect of reporting periods more than five years before an insurer's first IFRS reporting date.

5.10.9 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

Fair value option

In March 2004, the IASB issued *The Fair Value Option*, an exposure draft of proposed amendments to IAS 39. The exposure draft proposes to restrict the designation of an instrument at "fair value through profit or loss" to certain financial instruments. This may impact on an entity's ability to reclassify financial assets when the entity changes its accounting policy for insurance liabilities.

Insurance contracts phase II

The IASB sees IFRS 4 as a stepping stone in establishing the accounting for insurance contracts and it is committed to completing phase II without delay. Phase II on insurance contracts seeks to develop further some of the issues identified in the *Issues Paper Insurance* published in 1999. Any resulting standard would replace IFRS 4. One possibility contemplated is an asset and liability model that requires identification and measurement of individual assets and liabilities arising from insurance contracts at fair value. The timetable for this project is still to be determined by the Board.

Financial guarantees

The IASB intends to issue an exposure draft in the third quarter of 2004, proposing that financial guarantee contracts that meet the definition of an insurance contract, which are within the scope of IFRS 4, be accounted for initially at their fair value and subsequently at the higher of this amount, amortised in accordance with IAS 18 (see 4.2), and the provision (if any) required under IAS 37 (see 3.11).

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6. Transition to IFRSs

6.1 First-time adoption

(IFRS 1)

Overview

- **IFRS 1 sets out all transitional requirements and exemptions available on the first-time adoption of IFRSs.**
- **An opening balance sheet is prepared at the date of transition to IFRSs, which is the beginning of the earliest comparative period presented on the basis of IFRSs.**
- **Accounting policies are chosen from IFRSs in effect at the reporting date.**
- **Generally, those accounting policies must be applied retrospectively in preparing the opening balance sheet and all periods presented on the basis of IFRSs.**
- **A number of exemptions are available from the general requirement for retrospective application of IFRS accounting policies.**
- **Retrospective application of changes in policy is prohibited in some cases; generally when doing so would require hindsight.**
- **At least one year of comparative financial statements must be presented.**
- **First-time adoption of IFRSs may be reported initially in either annual or interim financial statements.**

IFRS 1 *First-time Adoption of IFRSs* is effective for accounting periods beginning on or after 1 January 2004 and replaces SIC–8 *First-Time Application of IASs as the Primary Basis of Accounting*.

IFRS 1 contains all transitional requirements applicable on the first application of IFRSs. An entity applying IFRS 1 does not apply the transitional provisions of individual standards unless specifically required to do so by IFRS 1. When appropriate, each new or revised standard issued since June 2003 has amended IFRS 1 to include any transitional requirements related to the application of that standard by a first-time adopter of IFRSs.

This section discusses the special requirements that apply to a first-time adopter presenting its financial statements in compliance with IFRSs for a period beginning on or after 1 January 2005. Therefore, this chapter assumes that an entity is required to apply the revised versions of IFRSs, as published in December 2003, and new standards and interpretations (i.e., IFRS 2, 3, 4 and 5 and IFRIC 1) whose adoption will be required in financial statements for an annual period beginning on or after 1 January 2005.

If an entity adopts IFRSs for a period beginning before 1 January 2005 but after 1 January 2004, application of IFRS 1 still is required, but the version of standards required to be applied by that entity would be different. For example, it would not be required to apply the revised standards as published in December 2003, the subsequent amendments to those standards or new standards that are not yet effective. However, early adoption of these standards by a first-time adopter is permitted.

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IFRS 1.9 Entities already applying IFRSs should refer to the transitional requirements of individual standards and to the general requirements applicable to changes of accounting policy (see 2.8). IFRS 1 does not apply to entities already reporting under IFRSs that comply for the first time with a new standard.

6.1.1 General requirements

Applicability

IFRS 1.2-4, 1.A The requirements and reliefs in IFRS 1 are applicable in an entity's *first IFRS financial statements*. These are the first annual financial statements in which an entity adopts IFRSs by an explicit and unreserved statement of compliance with IFRSs.

IFRS 1.2(b) The first-time adoption requirements and reliefs in IFRS 1 apply also to interim financial statements prepared in accordance with IAS 34 (see 5.9) for part of a period that will be covered by the entity's first IFRS financial statements.

Financial statements may be an entity's first IFRS financial statements if the *most recent* previous financial statements presented did not contain an explicit and unreserved statement of compliance with IFRSs or if the entity did not present financial statements for previous periods.

IFRS 1.3(b) In our view, financial statements have not been *presented* unless they are distributed outside the group, for example, to a lender. A group reporting package may constitute financial statements and may even include a statement of compliance with IFRSs. However, unless an entity's reporting package has been distributed outside a group the entity may still be a first-time adopter at a later date. An entity may become a first-time adopter later than its parent (see 6.1.6).

IFRS 1.3(c) An entity is a first-time adopter if it previously has complied with some, but not all, IFRSs (e.g., because previous GAAP required compliance with an individual standard) or when it complied with all IFRSs but did not include an explicit and unreserved statement of compliance with IFRSs. *Previous GAAP* is the basis of accounting that a first-time adopter used immediately before adopting IFRSs.

IFRS 1.25 An entity may be a first-time adopter at different dates in its separate and its consolidated financial statements. An entity that adopts IFRSs for its separate and consolidated financial statements at different dates is required to measure assets and liabilities at the same amount except for consolidation adjustments (see 6.1.6).

It may be possible for an entity to claim to be a first-time adopter more than once over a number of years in respect of the *same* set of financial statements (i.e., consolidated or separate). In our view, an entity that previously claimed compliance with IFRSs (or IASs) can be a first-time adopter under IFRS 1 if an explicit and unreserved statement of compliance was not included in its *most recently* published annual financial statements. The statement may have been omitted by choice or necessity, for example, when an entity had claimed that its previous GAAP financial statements also complied with IASs, but dropped the statement of compliance with IASs due to subsequent changes in national GAAP and / or IASs that made dual compliance impossible.

Each entity that prepares financial statements (i.e., each reporting entity) can be a first-time adopter. In our view, financial statements that are prepared for a part of the reporting entity do not make the entity as a whole a first-time adopter.

An entity does not have to be required to prepare IFRS financial statements in order to be a first-time adopter. Therefore, an entity that currently prepares its consolidated financial statements on an IFRS basis voluntarily (e.g., to distribute to foreign shareholders) would not be a first-time adopter in respect of its consolidated financial statements if it also was required subsequently to prepare its consolidated financial statements on an IFRS basis for statutory purposes.

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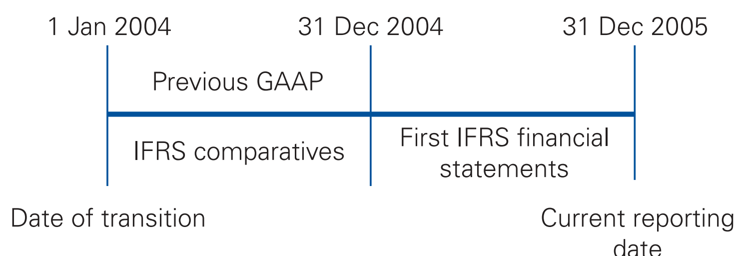
Date of transition

IFRS 1.6, 1.A An opening IFRS balance sheet must be prepared at the entity's date of transition. The date of transition is the start of the earliest comparative period presented in the entity's first IFRS financial statements.



IAS 1.36 In the diagram above, an entity adopting IFRSs for its 2005 annual financial statements has a date of transition to IFRSs of 1 January 2004. IFRSs require that comparative information is disclosed at least in respect of one previous reporting period (see 2.1). In our view, the previous reporting period need not be a year and must be the period presented previously, for example, if an entity had a 52-week financial year.

Accounting policies

IFRS 1.7 An entity selects accounting policies based on IFRSs that are effective at the current reporting date, or based on the permitted early application of standards that are not yet required to be adopted.

IFRS 1.7 Generally, those policies are applied consistently at the date of transition to restate the opening balance sheet to an IFRS basis and in each of the periods presented in the first IFRS financial statements, even if the standard does not require retrospective application for existing IFRS users. IFRS accounting policies are not applied consistently in two cases:

- when, under IFRS 1, requirements are applicable only prospectively from a date after the date of transition (see 6.1.2); and
- when the entity has chosen to apply exemptions from consistent application (see 6.1.2).

IFRS 1.42 The requirements that apply to an existing IFRS user regarding voluntary changes in accounting policy do not apply when an entity selects accounting policies under IFRSs for the first time. Accordingly, certain restrictions, for example on the change from a fair value model to a cost model for investment properties, do not apply to a first-time adopter. The disclosure requirements of IAS 8 for changes in accounting policies also do not apply (see 2.8).

Recognition and derecognition

IFRS 1.10 All assets and liabilities are recognised or derecognised as required or permitted by IFRSs.

IFRS 1.10(a) Assets and liabilities that are not recognised under previous GAAP at the date of transition but meet the requirements for recognition under IFRSs generally are recognised, for example:

- defined benefit plan assets or liabilities;
- deferred tax assets or liabilities;
- provisions for restoration costs on non-current assets; and
- amounts received that do not qualify for recognition as revenue are recognised as a liability (i.e., deferred income).

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IFRS 1.10(b) Assets and liabilities recognised under previous GAAP at the date of transition that do not meet the requirements for recognition under IFRSs are derecognised, for example:

- intangible assets that do not qualify for recognition (e.g., some internally generated intangible assets, all internally generated goodwill, capitalised start-up costs, or research expenditure, see 3.3); and
- liabilities for restructuring that do not meet the recognition requirements for a provision (see 3.11).

Classification

IFRS 1.10(c) Assets, liabilities and components of equity are classified as required by IFRSs, for example:

- some intangibles must be reclassified as goodwill and *vice versa*;
- some equity items must be reclassified as liabilities and *vice versa*; and
- reserves related to revaluations made under previous GAAP may be reclassified as retained earnings (see the deemed cost exemption in 6.1.2 below).

Measurement

IFRS 1.10(d) Recognised assets and liabilities are remeasured in accordance with the applicable IFRS, for example:

- provisions are measured on a discounted basis;
- deferred tax liabilities and assets are measured on an undiscounted basis; and
- investment properties are measured at fair value (when applicable, see 3.4).

The measurement of assets and liabilities must be in accordance with IFRSs, even if an item is measured under both previous GAAP and IFRS on a cost basis. For example, when property, plant and equipment is measured at cost, that amount must be measured in accordance with IAS 16 (see 3.2) unless an exemption as described below in 6.1.2 or 6.1.3 applies. Therefore, if start-up costs were capitalised as part of the cost of an asset under previous GAAP, the cost would have to be adjusted to remove any unamortised start-up costs.

IFRS 1.11 All adjustments resulting from the remeasurement of the previous GAAP balance sheet to the opening IFRS balance sheet are made to retained earnings or to a more appropriate component of equity at the date of transition unless the adjustment is required to be made to goodwill (see 6.1.5).

6.1.2 Prospective application and optional exemptions

IFRS 1.12, 13 Entities may elect to use one or more of the voluntary exemptions from the general requirement for retrospective application of IFRSs. Some of these must be applied to classes of items or transactions; others may be elected on an item-by-item basis. These voluntary exemptions relate to:

- business combinations;
- fair value or revaluation as deemed cost;
- employee benefits;
- cumulative foreign currency translation differences;
- compound financial instruments;
- assets and liabilities of subsidiaries, associates and joint ventures;
- designation of previously recognised financial instruments;
- share-based payment transactions;
- insurance contracts; and
- decommissioning liabilities included in the cost of property, plant and equipment.

IFRS 1.13 These exemptions may not be applied to other items by analogy.

In our view, more than one relevant exemption usually may be applied to a particular asset or liability. For example, an entity that elects not to restate a past business combination also may

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choose to apply the deemed cost exemption to an asset acquired in an unrestated business combination on the basis of a revaluation at the date of transition. Under the business combination exemption, the previous initial measurement at acquisition of the assets and liabilities acquired in the business combination generally becomes their deemed cost under IFRSs at the date of the acquisition (see 6.1.5). However, the additional application of the deemed cost exemption, at the date of transition, to an individual asset acquired in that unrestated business combination means that the valuation at that later date is adopted as its deemed cost in the opening IFRS balance sheet.

IFRS 1.25 However, certain exemptions may not be combined. For example, the exemption in respect of the assets and liabilities of subsidiaries that have adopted IFRSs before a parent (see 6.1.6) requires that the items are measured at the same carrying amounts as in the financial statements of the subsidiary. In our view, this requirement prevents the use of another exemption that would alter these carrying amounts (e.g., the deemed cost exemption).

The application of the exemptions is discussed further in 6.1.5.

6.1.3 Mandatory exceptions

IFRS 1.26 Retrospective application of some aspects of IFRSs are prohibited. Unlike the optional exemptions, first-time adopters must use these exceptions from the general requirement for retrospective application.

Derecognition of financial instruments

IFRS 1.27 Generally, a first-time adopter of IFRSs must apply the derecognition requirements of IFRSs (see 3.6) prospectively to transactions occurring on or after 1 January 2004 in respect of all non-derivative financial assets and liabilities. The accounting under an entity's previous GAAP for such assets and liabilities before that date is not altered, and financial assets and liabilities are not recognised to adjust the opening balance sheet to an IFRS basis in respect of these "grandfathered" transactions. Special transition requirements apply for entities adopting IFRSs on or before 1 January 2006 (see 6.1.5).

IFRS 1.27A However, an entity is permitted to apply the derecognition requirements of IFRSs retrospectively to a date of the entity's choosing, provided that the information needed to apply those requirements to financial assets and liabilities derecognised as a result of past transactions was obtained at the time of the initial accounting for those transactions.

Special purpose entities

There is no exemption from the consolidation requirements for SPEs.

An entity must consolidate all SPEs it controls at the date of transition, even if the SPEs were created before the date of transition to IFRSs or hold financial assets and liabilities that were derecognised by the transferor under previous GAAP.

Hedge accounting

IFRS 1.28 Hedge accounting may be applied from the date of transition only to hedging relationships that meet the requirements for hedge accounting at that date. Transactions may not be designated retrospectively as hedges. At the date of transition to IFRSs, an entity must:

- measure all derivatives at fair value; and
- eliminate any deferred gains and losses relating to derivatives that were reported as assets and liabilities under previous GAAP.

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IAS 39.91, 101, IFRS 1.29, 30

For transactions prior to the entity's date of transition to IFRSs, hedge accounting is applied if a hedging relationship qualifies for hedge accounting under its previous GAAP. At the date of transition, existing hedging relationships are reflected in the opening IFRS balance sheet by:

- recognising cumulative derivative gains and losses in a cash flow hedging reserve (for a cash flow hedge); and
- adjusting the hedged item (in a fair value hedge) with a corresponding adjustment to retained earnings.

This applies only for hedging relationships that qualify as such under IAS 39. It would not apply, for example, in the case of hedges using written options or a hedge of a net position.

However, an entity may designate an individual item within a net position as a hedged item if the entity, under its previous GAAP, had designated the net item as a hedged item. In these cases, the designation of an individual item must be done no later than the date of transition to IFRSs. However, special transition rules apply to entities adopting IFRSs on or before 1 January 2006 (see 6.1.5).

6.1.4 Estimates

IFRS 1.31

Estimates made at the date of transition and during the comparative period under previous GAAP should not be changed (except for the effect of the application of accounting policies under IFRSs to those estimates) unless there is objective evidence that those estimates were in error.

In our view, the requirement that estimates may not be revised (other than for errors and differences in accounting policies) means that estimates may not be changed until the start of the period in which the entity becomes a first-time adopter. When changes in estimate are appropriate, they are accounted for prospectively.

IFRS 1.33

When an entity needs to make estimates under IFRSs that were not required under previous GAAP, the estimates must reflect conditions at the date of transition to IFRSs. They cannot reflect conditions that arose after the date of transition to IFRSs.

6.1.5 Application issues

Business combinations

IFRS 1.15

All business combinations that occurred after the date of transition are restated in accordance with the standard effective at the reporting date (e.g., IFRS 3 for those entities with a date of transition of 1 January 2004, see 2.6).

IFRS 1.15, 1.B1

For business combinations that occurred before the transition date, entities have the following choices:

- restate all of these business combinations;
- restate all business combinations after a particular date; or
- do not restate any of those business combinations.

IFRS 1.B3

This exemption applies also to acquisitions before the transition date of investments in associates and interests in joint ventures.

If one business combination (or acquisition of an associate or joint venture interest) not required to be restated is restated voluntarily, then all subsequent business combinations and acquisitions must be restated.

IFRS 1.B

If business combinations are not restated, then the previous acquisition accounting remains unchanged. However, some adjustments (e.g., to reclassify intangibles and goodwill) may be required (see below).

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Definition of a business combination

In our view, the business combination exemption is available to all transactions that would be considered to be a business combination under IFRSs (i.e., to all business combinations as defined in IFRS 3), regardless of how the transaction was accounted for under previous GAAP. The exemption is not available for transactions that are described as business combinations under previous GAAP, but do not meet the definition of a business combination under IFRSs. In our view, the exemption is available even if the business combination is outside the scope of IFRS 3 (e.g., a common control transaction).

Recognition and derecognition

IFRS 1.B2(b) An entity is not required to recognise:

- some financial assets and liabilities derecognised under previous GAAP; and
- assets (including goodwill) and liabilities that were not recognised under previous GAAP and also would not qualify for recognition in the separate balance sheet of the acquiree.

All other assets and liabilities acquired in an unrestated business combination are recognised if the asset or liability qualifies for recognition under IFRSs (e.g., defined benefit plan liabilities and assets, deferred tax assets and liabilities). This must be done regardless of whether these assets and liabilities were recognised under previous GAAP. An entity may not treat previously unrecognised items as having a deemed cost of zero under previous GAAP.

IFRS 1.B2(c) Assets and liabilities acquired in an unrestated business combination that were recognised under previous GAAP but that do not qualify for recognition under IFRSs are derecognised (e.g., provision for a major overhaul or start-up costs).

IFRS 1.B2(b), (c) The resulting adjustments are recognised as adjustments of opening retained earnings, or some other appropriate part of equity, unless they relate to reclassifications between goodwill and intangible assets (see below).

IFRS 1.B2(f) If an asset or liability was not recognised under previous GAAP, the acquirer must recognise and measure the item in its *consolidated* opening IFRS balance sheet on the same basis that IFRSs would require in the *separate* balance sheet of the acquiree (e.g., an asset, and associated liability, under a previously unrecognised finance lease).

Measurement

IFRS 1.B2(e) The carrying value under previous GAAP of assets and liabilities acquired in an unrestated business combination immediately after the business combination equals deemed cost at that date.

IFRS 1.B2(d) If the accounting policy adopted by an entity under IFRSs require assets and liabilities to be measured subsequently on a basis that is not cost (e.g., fair value), assets and liabilities should be measured on that basis in the opening IFRS balance sheet.

IFRS 1.B2(k) Adjustments to assets and liabilities may impact the measurement of deferred tax and minority interests.

IFRS 1.B2(g), (i) Adjustments to deferred tax assets and liabilities must be recognised as an adjustment to retained earnings in the opening IFRS balance sheet, except when the adjustment relates to the recognition or derecognition of an intangible subsumed in recognised goodwill. In this case the adjustment is recognised as an adjustment of goodwill (see below under *Deferred tax*).

IFRS 1.B2(i) Most other adjustments to restate the opening IFRS balance sheet will be recognised directly in retained earnings or some other appropriate part of equity, except when there are adjustments made to the amount of goodwill recognised under previous GAAP. However, if goodwill has been eliminated against equity under previous GAAP, then adjustments to goodwill are made to retained earnings.

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IFRS 1.B2(g) The carrying amount of goodwill in the opening balance sheet must be its carrying amount under previous GAAP at the date of transition adjusted only for:

- reclassifications between goodwill and intangible assets;
- contingencies affecting the measurement of purchase consideration for a past business combination on an IFRS basis. Goodwill should be adjusted if the contingency is resolved before the IFRS transition date, or a reliable estimate can be made and payment is probable at the opening balance sheet date (see 2.6); and
- any impairment losses recognised.

Goodwill must be tested for impairment at the transition date, with any resulting loss recognised directly in retained earnings.

IFRS 3, which prohibits amortisation of goodwill and indefinite lived intangible assets, generally is applied prospectively from the opening balance sheet date. Amortisation of goodwill recognised under previous GAAP for unrestated business combinations cannot be adjusted or reversed unless IFRS 3 is applied from a date earlier than the IFRS transition date, together with the related amendments to the standards on impairment and intangible assets (see 2.6 and 3.3).

In-process research and development

IFRS 1.B2(f) If an entity recognised in-process research and development as an asset in an unrestated business combination and immediately wrote it down to zero under previous GAAP, IFRS 1 requires the entity to reverse this write-off and recognise an intangible asset unless the intangible asset would have been amortised fully at the opening balance sheet date. In our view, because the in-process research and development asset was recognised under previous GAAP, it may need to be recognised in the opening IFRS balance sheet, even though it may not qualify for recognition in the separate financial statements of the acquiree. We believe that the entity should consider if the amortisation policy used under previous GAAP of immediate write-down is appropriate under IFRSs. Instead, the intangible development asset is amortised from the date of the business combination. Any adjustments are recognised in retained earnings at the date of transition.

Unconsolidated subsidiaries

IFRS 1.B2(j) IFRSs require the consolidation of all subsidiaries (see 2.5). However, an entity's previous GAAP may not have required consolidation of an entity that is considered a subsidiary under IFRSs. This may occur because:

- previous GAAP did not require consolidation of certain subsidiaries (e.g., because the subsidiary had dissimilar operations to the parent or the subsidiary is held for sale); or
- the investment was not classified as a subsidiary under previous GAAP but would be under IFRSs (e.g., due to a different treatment of potential voting rights).

Special requirements apply regarding previously unconsolidated subsidiaries.

IFRS 1.B2(j) For example, a subsidiary may have been classified as an associate or a joint venture under previous GAAP, for example, because the definitions under previous GAAP of subsidiaries, associates and joint ventures are different from the definitions of those entities under IFRSs (see 2.5 and 3.5). The exemption from restatement for past business combinations also applies to past acquisitions of investments in associates and of interests in joint ventures. However, this exemption covers only the initial acquisition transaction. All subsidiaries must be consolidated in the opening IFRS balance sheet.

IFRS 1.B2(j) If a subsidiary was not consolidated under previous GAAP then the assets and liabilities of that subsidiary are recognised and measured in the opening IFRS balance sheet at the amount that IFRS would require in the subsidiary's separate balance sheet. Deemed goodwill is calculated by comparing the cost of the initial investment with the net assets (or net liabilities) under IFRSs of the

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investee at the date of transition. Changes in the net assets (or net liabilities) between the date of acquisition and the date of transition will affect the deemed cost of the goodwill under IFRSs.

In our view, the application of equity accounting is consolidation for the purposes of these requirements because we view the equity method as "one line consolidation" for this purpose. As a result, the amount of goodwill recognised for an entity that is a subsidiary under IFRS but was accounted for as an associate under previous GAAP will be the deemed cost of the goodwill under IFRSs, subject to the revisions of goodwill required by IFRSs as discussed above. Therefore, in the opening IFRS balance sheet and subsequently, an entity that is a subsidiary under IFRS but was accounted for under previous GAAP using the equity method would be consolidated on a line-by-line basis.

Foreign exchange translation

Cumulative foreign currency translation differences

IFRS 1.21, 22

IFRSs require that cumulative translation differences arising on the translation of a foreign operation are recognised as a separate component of equity (see 2.7). Under IFRS 1, a first-time adopter may either:

- apply IAS 21 (see 2.7) retrospectively to determine the cumulative translation differences that must be recognised in a separate part of equity at the date of transition; or
- deem the cumulative translation differences to be zero at the IFRS transition date, and reclassify any amounts recognised in accordance with previous GAAP at that date as retained earnings. If elected, the exemption must be applied to all foreign operations.

The gain or loss on the subsequent disposal of any foreign operation must *exclude* translation differences that arose before the transition date if an entity elected to reset the cumulative translation adjustment to zero at the IFRS transition date.

Foreign operations

IAS 21.47

IAS 21 (revised 2003) requires any goodwill and fair value adjustments arising on the acquisition of a foreign operation to be treated as part of the assets and liabilities of the foreign operation and translated at the closing exchange rate (see 2.7).

IFRS 1.B1A

However, a first-time adopter is not required to apply IAS 21 retrospectively to fair value adjustments and goodwill arising in business combinations that occurred before the date of transition to IFRSs.

IFRS 1.B1B

An entity is permitted, but not required, to apply revised IAS 21 either to all business combinations that occurred before the date of transition or to all restated business combinations.

IFRS 1.B1A

If an entity elects not to apply revised IAS 21 retrospectively to fair value adjustments and goodwill related to unrestated business combinations, then it is required to treat those items as assets and liabilities of the acquirer. As a result, those items are translated once at the date of acquisition into the acquirer's functional currency using the foreign currency translation requirements of the acquirer's previous GAAP.

Property, plant and equipment

Fair value or revaluation as deemed cost

The application of an IFRS accounting policy to measure property, plant and equipment at cost requires an entity to determine the cost of the asset measured in accordance with IFRSs.

IFRS 1.16, 17

Alternatively, the fair value or revaluation as deemed cost exemption permits the cost of an item of property, plant and equipment to be measured based on a deemed cost. The exemption may be applied to individual items of property, plant and equipment.

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IFRS 1.18 The exemption also may be applied to investment property and intangible assets, subject to additional criteria (see below).

IFRS 1.16, 17, 19 Deemed cost may be:

- fair value at the date of transition;
- a previous GAAP revaluation, provided that the revaluation broadly was similar to fair value, or cost or a depreciated cost measure under IFRSs adjusted to reflect, for example, changes in a general or specific price index; or
- an event-driven valuation, for example, when an entity was privatised or made an initial public offering and at that point valued and recognised some or all or its assets and liabilities at fair value.

The deemed cost exemption is applied as follows:

Deemed cost	**At what date?**
Fair value at transition date	Transition date
Previous revaluation broadly comparable to: • fair value; or • cost or depreciated cost adjusted for changes in a price index.	Date of valuation
Event-driven fair value measurement	Date of valuation

IFRS 1.44 Special disclosure requirements apply when the deemed cost option is used.

IFRS 1.16-19 In each case, the date of valuation must be at or before the date of transition to IFRSs. When the date of valuation is prior to the date of transition, the estimates made to estimate depreciation under previous GAAP are not revised except in the case of error (see below under *Depreciation rates and tax allowances*).

IFRS 1.10(c), 1.IG10 Assets recognised at deemed cost are not considered to be measured at a revalued amount for the purpose of IFRSs (see 3.2). Any revaluation reserve under previous GAAP that relates to the asset at the date that deemed cost is determined is reclassified either as a separate component of equity (not described as a revaluation reserve) or transferred to retained earnings. This amount cannot be used to offset future revaluation losses.

The revaluation surplus for assets measured at fair value at the transition date is the difference between the carrying amount of the asset and its cost (or deemed cost if the deemed cost exemption was elected).

For example, entity B has an owner-occupied property with a cost of 60 under previous GAAP and of 55 under IFRSs. Before the date of transition, the property was revalued to a fair value of 85 and a revaluation reserve of 25 was recognised under previous GAAP. Its fair value is 100 at the date of transition. Depreciation is ignored for the purpose of this example. B elects, as its accounting policy, to measure the class of asset that includes this property on a fair value basis (see 3.2). At the date of transition, the revaluation reserve of 25 recognised under previous GAAP is reclassified as retained earnings. Depending upon the exemptions chosen by B, the IFRS revaluation reserve at the date of transition will be as follows.

- If the deemed cost exemption is not elected, the IFRS revaluation reserve will be 45 (100 - 55), based on the IFRS cost of the asset.

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- If the deemed cost exemption is applied on the basis of the revaluation at the date of transition, the IFRS revaluation reserve will be zero (100 - 100), based on the revaluation at the date of transition as deemed cost.
- If the deemed cost exemption is applied on the basis of the earlier revaluation, the IFRS revaluation reserve at the date of transition to IFRS will be 15 (100 - 85), based on that earlier revaluation as deemed cost.

Deemed cost for assets held under finance lease

IAS 16.4, 17.27-30

An entity applies the leasing requirements of IFRSs to classify any leases in effect at its date of transition to IFRSs as operating or finance leases (see 5.1). Assets held under finance leases are accounted for as own assets, for example, property, plant and equipment (see 3.2), subject to the additional leasing requirements regarding initial recognition, measurement of cost and depreciation.

In our view, the deemed cost exemption for property, plant and equipment may be applied to an asset acquired under a finance lease.

Decommissioning liabilities

IFRS 1.25E, IFRIC 1

Generally, changes in decommissioning liabilities are added to or deducted from the cost of the relevant asset as estimates change. However, a first-time adopter need not retrospectively calculate the effect of each change that occurred prior to the date of transition. Instead, a first-time adopter includes in the opening IFRS balance sheet the provision required by IFRSs at that date (see 3.11), estimates the amount that would have been included in the cost of the asset when the liability arose using its best estimate of historical risk-adjusted discount rates and estimates the accumulated depreciation on that amount using current estimates of useful life.

When fair value is used as deemed cost, the valuation is grossed up for any provision for restoration. For example, the fair value of a property is 90,000. That fair value is net of a provision of 20,000 for the present value of expected future costs required to restore the site at the end of its useful life. IFRSs require provisions for site restoration to be recognised separately as liabilities; these liabilities may not be netted against the carrying value of the related asset. Therefore, the fair value used to establish deemed cost is 110,000.

Depreciation rates and tax allowances

IFRS 1.31-34, 1.IG7

Estimates made under previous GAAP may not be revised at the date of transition or at the end of a comparative period unless they are in error. Errors are corrected in the opening IFRS balance sheet and disclosed separately in the reconciliations required from previous GAAP to IFRSs (see 6.1.7). Changes in estimates to reflect changing circumstances are dealt with prospectively (i.e., from the date of transition to IFRSs).

Depreciation is an accounting estimate and therefore changes in depreciation normally are dealt with prospectively. However, IFRS 1 states that when cumulative depreciation at the date of transition was based on tax allowances, an error exists that should be adjusted in the opening IFRS balance sheet. Therefore, if an entity previously depreciated an item of equipment based upon tax allowances, without reference to the economic useful life of the asset or to its residual value, then an adjustment to measure depreciation based on the economic useful life of the asset or its residual value is recognised as an adjustment of opening retained earnings. In our view, in the case of depreciation properly recognised in accordance with previous GAAP, disclosure within the reconciliations of the adjustment to cumulative depreciation together with a suitable description generally also will satisfy the disclosure requirements regarding the correction of an error.

Components

No exemptions are available from identifying parts of property, plant and equipment that are required to be accounted for separately under IFRSs (usually referred to as *components*). In our view,

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identification and separate recognition of components is required in the opening IFRS balance sheet. For example, IFRSs require major inspection and overhaul to be identified as a separate component of the asset and depreciated (see 3.2).

IFRS 1.IG12 Component accounting affects the subsequent accounting for both cost and depreciation (see 3.2). Accordingly, both cost and accumulated depreciation should be allocated to separately identified components.

We expect that, generally, this allocation will not result in any significant adjustment to the net book value of the asset, except when the depreciation of the asset as a whole previously was in error from an IFRS perspective (see above), or when the adjustment also includes derecognition of provisions for routine repairs and maintenance that were recognised under previous GAAP.

IAS 16.14 When the original cost of a major inspection or overhaul is not available, the expected cost of the next overhaul may be the best estimate of the cost of the component. In our view, a similar approach is acceptable for measuring major inspection and overhaul costs in the opening IFRS balance sheet.

Intangible assets and goodwill

Fair value or revaluation as deemed cost

The application of an IFRS accounting policy to measure an intangible asset at cost requires determination of the cost of the asset, measured in accordance with IFRSs.

IFRS 1.16-19 Alternatively, the fair value or revaluation at deemed cost exemption permits intangible assets (see 3.3) to be recognised at deemed cost, provided that the intangible asset meets the recognition criteria of IFRSs.

The exemption may be applied to individual intangible assets.

Deemed cost may be:

- fair value at the date of transition;
- a previous GAAP revaluation, provided that the revaluation broadly was similar to fair value, or cost or a depreciated cost measure under IFRSs adjusted to reflect, for example, changes in a general or specific price index; or
- an event-driven valuation, for example, when an entity was privatised or made an initial public offering and at that point valued and recognised some or all or its assets and liabilities at fair value.

IFRS 1.16-19 However, for deemed cost to be determined by reference to fair value at the date of transition or a previous GAAP revaluation, then the asset also must satisfy the criteria for revaluation of intangibles (see 3.3).

The criteria for revaluation (including the existence of an active market) must be met to use the deemed cost exemption even if the intangible subsequently will be measured on the basis of cost under IFRSs.

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The deemed cost exemption is applied as follows:

Deemed cost	At what date?
Fair value at transition date	Transition date
Previous revaluation broadly comparable to: • fair value; or • cost or depreciated cost adjusted for changes in a price index.	Date of valuation
Event-driven fair value measurement	Date of valuation

IFRS 1.44 Special disclosure requirements apply when the deemed cost option is used.

In each case, the date of valuation must be at or before the date of transition to IFRSs.

IFRS 1.10(c), 1.IG10 Assets recognised at deemed cost are not considered to be measured at a revalued amount for the purpose of IFRSs (see 3.2). Any revaluation reserve that relates to the asset at the date that the deemed cost is determined is reclassified either as a separate component of equity (not described as a revaluation reserve) or transferred to retained earnings. This amount cannot be used to offset future revaluation losses.

An entity determines the revaluation surplus for intangibles measured at fair value at the transition date as the difference between the carrying amount of the asset and its cost or deemed cost (see the example under *Property, plant and equipment* above).

Intangible assets acquired separately

IFRS 1.7 Full retrospective application of all standards effective at the entity's first IFRS reporting date is required for intangible assets acquired separately (i.e., outside a business combination) for example, licences or patents.

Internally generated intangible assets

A first-time adopter is required to recognise in its opening IFRS balance sheet all internally generated intangible assets that qualify for recognition under IFRSs (see 3.3).

IAS 38.57 IFRS 1.IG46 The criteria for recognition of internally generated intangibles may not be assessed using hindsight. In our view, the interaction of this prohibition on the use of hindsight with the requirements of IFRS 1 should be interpreted as requiring either:

- contemporaneous evidence that all of the recognition requirements of IFRSs were considered at the time when the expenditure was incurred. Expenditure should be capitalised only from the date when it can be demonstrated that this information was available; or
- the existence of a process or control system to ensure that no expenditure of this nature is incurred without all recognition requirements having been considered. This might be the case if, for example, the entity had a well-managed product development programme that considered all of the recognition criteria and there is no reason to believe that the normal process or control system was not followed.

Entities with extensive development programmes may have control procedures in place to assess the probability of future economic benefits periodically. In our view, if an entity has such a monitoring system, and if the costs incurred were measured reliably, then this data is likely to satisfy the requirements of IFRSs for contemporaneous assessment of the probability of future economic benefits.

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For example, an entity had an option under its previous GAAP to capitalise or expense the cost of internally generated intangibles. As part of its management system for monitoring spending on research and development the entity has contemporaneous documentation that the recognition criteria of IFRSs for intangibles were met in 2002 but the entity chose not to recognise these assets under its previous GAAP. In the entity's opening IFRS balance sheet at 1 January 2004 it must recognise an intangible asset, remeasured at amortised cost (unless it qualifies for, and uses, a deemed cost exemption).

Negative goodwill

IFRS 1.15, 3.56

An entity must eliminate negative goodwill recognised under previous GAAP. When negative goodwill arises in a business combination that occurs after the date of transition, an entity must reconsider its identification and measurement of the identifiable assets, liabilities and contingent liabilities and the cost of the combination. Any amount remaining after this reconsideration is recognised immediately in the income statement. When an entity elects to restate a business combination that occurred before the date of transition, the same reconsideration is required. Any amount remaining after this reconsideration is recognised in equity (see 2.5).

Negative goodwill that arose in an unrestated business combination is included in retained earnings at the date of transition. In our view, when negative goodwill was recognised under previous GAAP, there is no requirement to reassess the allocation of fair values in an unrestated business combination.

Investment property

Fair value or revaluation as deemed cost

The application of an IFRS accounting policy to measure an investment property at cost requires the determination of the cost of the asset measured in accordance with IFRSs.

IFRS 1.16-19

Alternatively, the fair value or revaluation as deemed cost exemption permits investment property to be recognised at deemed cost, provided that the entity elects to use the cost model for investment properties (see 3.4). If an entity elects to measure its investment properties at fair value, fair value at the date of transition also may be used as the deemed cost at that date.

The deemed cost exemption may be applied to individual properties.

Deemed cost may be:

- fair value at the date of transition;
- a previous GAAP revaluation, provided that the revaluation broadly was similar to fair value, or cost or a depreciated cost measure under IFRSs adjusted to reflect, for example, changes in a general or specific price index; or
- an event-driven valuation, for example, when an entity was privatised or made an initial public offering and at that point valued and recognised some or all or its assets and liabilities at fair value.

The deemed cost exemption is applied as follows:

Deemed cost	At what date?
Fair value at transition date	Transition date
Previous revaluation broadly comparable to: • fair value; or • cost or depreciated cost adjusted for changes in a price index.	Date of valuation
Event-driven fair value measurement	Date of valuation

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IFRS 1.44 Special disclosure requirements apply when the deemed cost option is used.

In each case, the date of valuation must be at or before the date of transition to IFRSs.

IFRS 1.10(c), 1.IG10 Assets recognised at deemed cost are not considered to be measured at a revalued amount for the purpose of IFRSs (see 3.2). Any revaluation reserve that relates to the asset is reclassified either as a separate component of equity (not described as a revaluation reserve) or transferred to retained earnings (see the example under *Property, plant and equipment* above).

Investments in associates and joint ventures

IFRS 1.15 All acquisitions of associates and joint ventures that occurred after the date of transition are restated in accordance with the standards effective at the reporting date (see 3.5).

IFRS 1.15 For acquisitions of associates and joint ventures that occurred before the transition date, the business combination exemption may be applied (see 6.1.2 and *Business combinations* above).

Financial instruments, including hedging

Compound financial instruments

IAS 32.28, IFRS 1.23 Compound financial instruments are split at inception into separate liability and equity components (see 5.6). If the liability component no longer is outstanding at the transition date, then an entity may elect not to separate the amount recognised in equity into:

- retained earnings (cumulative interest accreted on the liability component); and
- issued equity.

In our view, this election may be made on an instrument-by-instrument basis.

Transitional requirements for the recognition, derecognition and designation of financial instruments

IFRS 1.36A Generally, first-time adopters are required to apply recognition and measurement requirements of IFRSs for financial assets and liabilities (see 3.6) *retrospectively* from their date of transition to IFRSs. However, an entity whose date of adoption of IFRSs (i.e., the beginning of its first IFRS annual reporting period) is before 1 January 2006 may elect not to apply IAS 32, IAS 39 and IFRS 4 (together) in its comparative periods. An entity that elects not to restate comparatives to comply with IAS 32, IAS 39 and IFRS 4 must disclose the effect of this election (without quantification). In respect of these three standards only, the date of transition for the purposes of IFRS 1 is the beginning of the first IFRS annual reporting period and not the beginning of the comparative period. The effect of applying the three standards must be disclosed as required by IAS 8 (see 2.8).

In our view, this election cannot be made on an item-by-item basis, and requires application of the entity's previous GAAP to all transactions within the scope of the three standards. We believe that an entity may not use accounting policies other than those it used under its previous GAAP for unrestated comparative information.

IFRS 1.25A The requirements in IFRSs for financial instrument recognition and measurement permit a financial instrument to be designated on initial recognition as a financial asset or liability at "fair value through profit or loss", or as "available-for-sale" (see 3.6). IFRS 1 permits an entity to make such a designation at the date of transition, including at the beginning of the first IFRS annual reporting period if the entity elects not to restate comparatives to comply with IAS 32, IAS 39 and IFRS 4 (see above).

Impairment

IFRS 1.7, 1.IG39 An entity is required to apply the impairment requirements of IFRSs at the date of transition and throughout all subsequent periods presented in its first IFRS financial statements (see 3.9).

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IFRS 1.31, 1.IG40

Impairment testing often requires the use of significant estimates. As discussed in 6.1.4, estimates made at the date of transition and at the end of the comparative period under previous GAAP should not be changed (except for the effect of differences in accounting policies), unless there is objective evidence that those estimates were in error. This prohibition on revising estimates applies to cash flow estimates that are the basis for impairment tests under IFRSs (see 3.9).

When an entity needs to make estimates under IFRSs that were not required under its previous GAAP, for example, because its previous GAAP did not require value in use to be calculated, additional estimates should made for preparing the entity's first IFRS financial statements. These estimates must reflect conditions at the date of transition to IFRSs. They cannot reflect conditions that arose after the date of transition to IFRSs. In our view, if an entity was required to make similar estimates under its previous GAAP, but not required to discount those estimates, it uses the same estimates for its IFRS financial statements but discounts the amounts estimated previously. The effect of discounting on previous estimates is recognised as an adjustment to retained earnings at the date of transition.

IFRS 1.IG43

The requirements of IFRSs concerning the reversal of impairment losses (see 3.9) apply equally to losses recognised under IFRSs (including those recognised on transition to IFRS) and under previous GAAP.

However, impairment losses are not reversed if an entity elected to measure the related asset based on deemed cost (see above) at a date after the original impairment.

Equity

IFRS 1.10(c), 1.IG10

Components of equity at the date of transition are reclassified as required by IFRSs. For example, if an entity adopts the alternative treatment of revaluation for some or all classes of property, plant and equipment (see 3.2), then a revaluation reserve is presented as a separate component of equity.

Revaluation reserves

IFRS 1.IG10

At the date of transition, the revaluation reserve under IFRSs is measured as the difference between cost or deemed cost (when the deemed cost exemption is elected) and the carrying amount of the asset at that date (see the example under *Property, plant and equipment* above).

Cumulative translation differences

See above under *Foreign exchange translation*.

Compound financial instruments

See above under *Financial instruments, including hedging*.

Provisions

Generally, provisions for repairs and maintenance must be derecognised in the opening IFRS balance sheet (see 3.11). In our view, the derecognition of such a provision is an indication that a component of the relevant asset may need to be identified separately (see 3.2). The identification of components of property, plant and equipment on first-time adoption of IFRS is discussed above under *Property, plant and equipment*.

Deferred tax

At the date of transition

IFRS 1.B2(k)

Deferred tax assets and liabilities must be adjusted to (i) reflect any adjustments to book value recognised as a result of adopting IFRSs; and (ii) to measure deferred tax assets and deferred tax liabilities in accordance with the requirements of IFRSs (see 3.12).

IFRS 1.IG5

If there is a taxable temporary difference in the opening IFRS balance sheet, then a deferred tax liability should be recognised in that opening IFRS balance sheet. If the temporary difference relates

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to an intangible asset acquired in an earlier business combination, then recognition of the adjustment will depend upon whether that past business combination is restated and, if not restated, whether the intangible must be recognised or derecognised under IFRSs in the opening IFRS balance sheet (see above under *Intangible assets and goodwill*).

- If the business combination is restated, then the intangible asset (e.g., a customer list) and any deferred tax liability are recognised at that date. As a result, the adjustment to recognise the deferred tax liability would adjust the previous GAAP goodwill balance.
- If the business combination is not restated and the intangible is either recognised or derecognised at the date of transition, then the recognition of any deferred tax asset or liability is an adjustment to goodwill, together with the recognition or derecognition of the intangible.
- If the business combination is not restated and the intangible is neither recognised nor derecognised at the date of transition, then any deferred tax asset or liability is an adjustment to retained earnings (or another appropriate category of equity).

Subsequent measurement

IAS 12.61, 62

Generally, changes in the carrying amount of deferred tax that relate to changes in the related temporary differences should be recognised in the income statement. Other changes, for example, resulting from changes in tax rates, are recognised in the income statement unless they relate to items previously charged or credited directly to equity. An example of an item credited directly to equity is the impact of a change in accounting policy adjusted against opening retained earnings (see 2.8).

To the extent that a first-time adopter of IFRSs adjusts opening retained earnings at the date of transition and in doing so creates temporary differences, the entity will recognise the related changes in deferred tax assets and liabilities as changes in opening retained earnings. In our view, the entity should recognise directly in equity any subsequent changes in deferred taxes on those differences, to the extent that they do not arise from changes in the amount of the related temporary differences (e.g., a change in tax rates or tax laws).

Revenue

IAS 18 30, 39.9, 39.AG5-AG8

IFRSs require interest revenue to be recognised using the effective interest method (see 4.6).

IFRS 1.36A, IAS 18.30

An entity applying IFRSs for the first time before 1 January 2006 does not need to restate its comparative information with respect to IAS 32 and IAS 39 (see above under *Financial instruments, including hedging*). However, IFRSs do not include an explicit exemption in respect of the application of the guidance in IAS 39 to the recognition of revenue, which is covered by IAS 18.

In our view, it was not intended that the effective interest rate method explained in IAS 39 be applied in the comparative period. Accordingly, we believe that when an entity previously recognised interest revenue on a different basis (e.g., a straight-line basis), it need not revise its comparative figures in its first IFRS financial statements. The effective interest method is applied in the recognition of interest revenue from the date of transition applicable for IAS 32 and IAS 39 (e.g., 1 January 2005), based on the carrying amount of the related asset at that date.

Employee benefits

Retrospective calculation of the "corridor" for defined benefit plans

Generally, IFRS 1 requires all existing standards to be applied retrospectively to measure the opening IFRS balance sheet. This requirement overrides the normal transition requirement of other IFRSs, including the requirement concerning the deferral of actuarial gains and losses upon adoption of IAS 19 no later than 1 January 1999 (see 4.4). As a result, an entity applying IFRS 1 would have to recalculate all actuarial gains and losses from inception of each post-retirement and other long-term defined benefit plan if it intended to use a "corridor" approach to recognising actuarial gains and losses.

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IFRS 1.20 Alternatively, in respect of actuarial gains and losses for a defined benefit plan, an entity may elect to apply the exemption in IFRS 1 to recognise all cumulative actuarial gains and losses at the date of transition to IFRSs as an adjustment to opening retained earnings (or other appropriate part of equity). This option is available even if the entity will apply the corridor approach thereafter.

An election to use the IFRS 1 exemption must be applied to all defined benefit plans and cannot be applied on a plan-by-plan basis.

When a subsidiary of the reporting entity already applies IFRSs, the interaction with the requirements that apply when a subsidiary is an earlier adopter of IFRSs than its parent also must be considered. As explained in 6.1.6, when a subsidiary adopts IFRSs before its parent, the parent is required to measure the assets and liabilities of the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, including defined benefit obligations (subject only to consolidation adjustments and the effect of business combinations). In our view, this requirement regarding subsidiaries overrides the requirement to apply the defined benefit plan exemption to all plans. Accordingly, the unrecognised actuarial gains and losses related to the defined benefit plan of the subsidiary could not be recognised at the parent's date of transition.

However, if the group adopted an accounting policy of immediate recognition of all actuarial gains and losses, the unrecognised actuarial gains and losses related to the defined benefit plan of the subsidiary would be recognised in the opening IFRS balance sheet at the date of transition of the parent as a consolidation adjustment to align their accounting policies.

Estimates

IAS 19.72, IFRS 1.31 Measurement of employee benefit obligations under IFRSs require an entity to make demographic assumptions, for example, to select mortality tables. An entity's estimates under IFRSs at the date of transition to IFRSs must be consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error (see 6.1.4). In our view, if the assumptions made under previous GAAP are consistent with the methodologies and assumptions required under IFRSs, then the same mortality tables should be used to determine the defined benefit obligation, unless there is objective evidence that those estimates were in error.

Share-based payments

IFRS 1.25B-C Generally, IFRS recognition and measurement requirements for share-based payments apply prospectively for equity-settled instruments granted on or after 7 November 2002 (see 4.5A).

An entity that is a first-time adopter of IFRS may elect to:

- apply IFRS 2 recognition and measurement requirements regarding share-based payments retrospectively to all share-based payment transactions occurring before its transition date; or
- not apply recognition and measurement requirements regarding share-based payments retrospectively to:
  - equity instruments that were granted on or before 7 November 2002;
  - equity instruments that were granted after 7 November 2002 that vested before the later of:
    - the date of transition to IFRSs; and
    - 1 January 2005; or
  - liabilities arising from share-based payment transactions that were settled before the later of:
    - the date of transition to IFRSs; and
    - 1 January 2005.

However, IFRS 2 must be applied to liabilities arising from share-based payment transactions that are not settled by the later of 1 January 2005 and the date of transition to IFRSs.

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IFRS 1.25B An entity that elects to apply the IFRS 2 recognition and measurement requirement to instruments for which this is not required may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date. In our view, fair value should have been disclosed prior to publication of the first IFRS financial statements; it does not have to have been disclosed publicly at the time of grant.

In our view, voluntary application of the recognition and measurement requirements of IFRS 2 may be applied on a grant-by-grant basis. We believe that a grant-by-grant election is possible since adoption is encouraged when possible and availability of the required fair value data may vary for grants made at different dates.

IFRS 1.25B, 2.44, 45 The disclosure requirements apply to all share-based payment transactions, including grants to which the recognition and measurement requirements of IFRS 2 have not been applied.

For modifications to the terms or conditions of a grant of equity instruments occurring:

- before 1 January 2005 (or the date of transition, if later), the recognition and measurement requirements of IFRSs for share-based payments are not required to be applied when the original grant is not accounted for under those recognition and measurement requirements; and
- on or after 1 January 2005 (or the date of transition, if later), the recognition and measurement requirements of IFRSs for share-based payments must be applied, even if the original grant was not accounted for under those recognition and measurement requirements.

Leases

IFRS 1.7, 1.IG14 An entity must, at the date of transition, classify leases as operating or finance leases based on circumstances existing at the inception of the lease (unless the agreement is changed). The classification should be based on IFRSs effective at the reporting date for its first IFRS financial statements.

IFRS 1.IG14 If a lease agreement is changed between the inception of the lease and the date of transition to IFRSs, then the classification of the lease under IFRSs is tested using both the original and the revised terms based on the circumstances (and therefore the assumptions and estimates that were, or would have been used) at the inception of the original lease. If the revisions would result in a different classification using the original assumptions, then the revisions are treated as a new lease from the modification date, and the classification, recognition and measurement of the lease are determined using assumptions that were, or would have been, used as of the modification date.

Land and buildings

IAS 17.14 In the opening IFRS balance sheet, leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, then the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease.

IAS 17.7-19 A lease of both land and building should be treated as two leases, one for the land and one for the building, with each lease classified separately under IFRSs (see 5.1).

Assets held for sale and discontinued operations

IFRS 5.43 Generally, IFRS 5 is applied prospectively for annual reporting periods that begin on or after 1 January 2005 for entities already reporting under IFRSs.

IFRS 1.34B First-time adopters with a date of transition after 1 January 2005 are required to apply the standard retrospectively. This will require non-current assets and disposal groups to be classified as held for sale from the date that they met the relevant criteria, and for comparatives to be restated when appropriate. If assets and disposal groups qualify as held for sale at the date of transition,

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measurement of those items in the opening IFRS balance sheet and subsequent periods is based on IFRS 5 (see 5.4A). The impact of the retrospective application of IFRS 5 is an adjustment to opening retained earnings or another appropriate equity classification (see 6.1.1).

IFRS 1.34B First-time adopters with a date of transition before 1 January 2005 apply the transitional provisions in IFRS 5 applicable to an existing IFRS user (see 5.4A).

IFRS 1.34A, 5.43 A first-time adopter is permitted to apply IFRS 5 to all non-current assets (or disposal groups) that meet the criteria to be classified as held for sale and operations that meet the criteria to be classified as discontinued after any date before the effective date of IFRS 5, provided that the valuations and other information needed to apply IFRS 5 were obtained at the time those criteria originally were met.

6.1.6 Assets and liabilities in separate and consolidated financial statements

IFRS 1.24, 25 Determining when an entity has adopted IFRSs for the first time is discussed in section 6.1.1. It is possible that individual entities in a group (i.e., a parent and its subsidiaries) or their associates and joint ventures will adopt IFRSs at a different date (i.e., each may have a different date of transition). IFRS 1 contains special requirements and exemptions when this is the case.

The exemptions and related requirements apply to subsidiaries, associates and joint ventures.

Adoption in parent's separate and consolidated financial statements

IFRS 1.25 When a parent adopts IFRSs in its separate financial statements earlier or later than in its consolidated financial statements, it must measure its assets and liabilities at the same amounts in both sets of financial statements, except for consolidation adjustments.

Adoption by a subsidiary occurs later than by its parent

IFRS 1.24 When a subsidiary becomes a first-time adopter later than its parent, the subsidiary may measure its assets and liabilities at either:

- the amounts included in the consolidated financial statements, based on the parent's date of transition (excluding the effects of consolidation procedures and the business combination in which the parent acquired the subsidiary); or
- the carrying amounts required by IFRS 1 based on the subsidiary's own date of transition to IFRSs.

In our view, consolidation procedures include accounting policy adjustments. Accordingly, the amounts included in the consolidated financial statements should be adjusted to apply consistently the accounting policies of the subsidiary at the date of transition. For example, if the parent adopts a policy of revaluation for measuring a particular class of property, but the subsidiary adopts a policy of cost, then the amounts included in the consolidated financial statements in respect of the subsidiary should be adjusted to apply the subsidiary's policy when establishing the subsidiary's opening IFRS balance sheet.

Adoption by a parent occurs later than by its subsidiary

IFRS 1.25 When a parent is a first-time adopter later than its subsidiary, the consolidated financial statements of the parent must measure the assets and liabilities of the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for the effects of consolidation procedures and business combinations.

In our view, consolidation adjustments required to determine the amounts to be recognised in the parent's consolidated financial statements include accounting policy alignments. Accordingly, if a subsidiary adopted accounting policies under IFRSs that differ from group policies, then adjustments are required to the subsidiary's financial statements to establish the subsidiary's balance sheet for inclusion in the group's opening IFRS balance sheet.

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For example, a parent adopts an accounting policy under IFRSs in its consolidated financial statements that recognises all cumulative actuarial gains and losses relating to defined benefit plans immediately. A subsidiary has an accounting policy under IFRSs to apply a "corridor" (i.e., there are unrecognised actuarial gains and losses related to its defined benefit plan). In our view, when preparing its consolidated first IFRS financial statements, the parent makes consolidation adjustments to recognise all cumulative actuarial gains and losses.

In another example, a subsidiary applies a policy of revaluation to an item of property that it purchased separately after the subsidiary was acquired by its parent. In adopting IFRSs, the parent chooses the cost model as the group accounting policy. Therefore, the asset is restated to be included at cost in the opening IFRS's balance sheet of the group.

In our view, a parent may not apply the deemed cost exemption to establish a subsidiary's opening IFRS balance sheet if the subsidiary adopted IFRSs before the group. This is because of the requirement to measure the assets and liabilities of the subsidiary at the same carrying amounts as in the subsidiary, subject to specific adjustments including those made to align their accounting policies. In this respect, we believe that the application of the exemptions themselves are not accounting policy choices.

IFRS 1.25 A subsidiary may become a first-time adopter earlier than its parent as a result of applying IFRSs in either its separate financial statements or in its consolidated financial statements if the subsidiary is itself a parent.

In our view, the parent entity is required to use the same carrying amounts of assets and liabilities for the subsidiary as in the relevant IFRS financial statements of the subsidiary that cause it to be an earlier first-time adopter. Therefore, if the subsidiary is an earlier adopter of IFRSs as a result of its consolidated financial statements, it is the subsidiary's consolidated financial statements that should be the basis for the measurement of the assets and liabilities of the sub-group in the parent's first consolidated IFRS financial statements.

6.1.7 Presentation and disclosure

First IFRS financial statements

Extensive disclosures are required in the first IFRS financial statements to explain how the transition from previous GAAP to IFRSs affected the reported financial position, financial performance and cash flows of the entity. These disclosures include reconciliations of equity and reported profit and loss at the date of transition and at the end of the comparative period.

The reconciliations must show the material adjustments made to amounts reported under previous GAAP in order to determine corresponding amounts presented under IFRSs, together with explanations of the reconciling items. The correction of errors made under previous GAAP are identified separately.

IFRS 1.40 An entity that presented a cash flow statement under previous GAAP also must explain the material adjustments to its cash flow statement, if any.

For examples of such disclosures, see KPMG's *Illustrative financial statements* series.

Interim financial statements

IFRS 1.45(b) The extensive disclosures required in the first IFRS financial statements (see above) also must be given in any interim financial statements prepared in accordance with IAS 34 (see 5.9) for part of the period covered by the first IFRS financial statements. Alternatively, the interims must include a cross reference to another published document that contains those disclosures.

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IFRS 1.45(a) In addition, if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, additional reconciliations must be included in its first IFRS interim financial statements. These are reconciliations of its equity at the end of that comparable interim period and profit and loss for that comparable interim period (current and year-to-date).

IFRS 1.46 Interim financial statements also must disclose "any events or transactions that are material to an understanding of the current interim period". In the first interims prepared under IFRSs, this may require additional information to be given. Alternatively, the interims must include a cross reference to another published document that contain those disclosures.

For example, in our view, it will be appropriate to provide descriptions of significant accounting policies under IFRSs. Ordinarily, accounting policies would have been disclosed in the financial statements of the previous period and would not be repeated in interims of the following period, unless changes have been made.

6.1.8 Future developments

This publication is based on IFRSs in issue at 1 August 2004. When a significant change to the requirements of those IFRSs is expected, it is highlighted in the text and the principal changes are discussed briefly below.

In the case of this topic no future developments are noted. However, it is expected that when appropriate each new standard issued will amend IFRS 1 to include any transitional requirements related to the application of that standard by a first-time adopter of IFRSs.

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Appendix 1

Abbreviations

AICPA	American Institute of Certified Public Accountants
CGU	Cash generating unit
CPI	Consumer price index
DRC	Depreciated replacement cost
EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortisation
EITF	US Emerging Issues Task Force
EPS	Earnings per share
FASB	Financial Accounting Standards Board
FIFO	First-in first-out
Framework	The IASB's *Framework for the Preparation and Presentation of Financial Statements*
GAAP	Generally accepted accounting principles
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASs	International Accounting Standards
IFRIC	International Financial Reporting Interpretations Committee
IFRSs	International Financial Reporting Standards
IPO	Initial public offering
ISO	International Organisation for Standardisation
ITC	Investment tax credit
LIBOR	London inter bank offered rate
LIFO	Last-in first-out
PCAOB	Public Company Accounting Oversight Board
PPI	Producer price index
SAC	Standards Advisory Council
SEC	US Securities and Exchange Commission
SIC	Standing Interpretations Committee
SPE	Special purpose entity
STC	Secondary tax
WACC	Weighted average cost of capital
WPI	Wholesale price index

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Appendix 2

List of IFRSs in issue at 1 August 2004

IAS 1 Presentation of Financial Statements (revised 2004)

IAS 2 Inventories (revised 2003)

IAS 7 Cash Flow Statements (revised 2003)

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (revised 2003)

IAS 10 Events After the Balance Sheet Date (revised 2004)

IAS 11 Construction Contracts (revised 1993)

IAS 12 Income Taxes (revised 2004)

IAS 14 Segment Reporting (revised 2004)

IAS 15 Information Reflecting the Effects of Changing Prices
Withdrawn effective for annual periods beginning on or after 1 January 2005

IAS 16 Property, Plant and Equipment (revised 2004)

IAS 17 Leases (revised 2004)

IAS 18 Revenue (revised 2004)

IAS 19 Employee Benefits (revised 2004)

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance (revised 2003)

IAS 21 The Effects of Changes in Foreign Exchange Rates (revised 2003)

IAS 22 Business Combinations (superseded by IFRS 3 Business Combinations)

IAS 23 Borrowing Costs (revised 2003)

IAS 24 Related Party Disclosures (revised 2003)

IAS 26 Accounting and Reporting by Retirement Benefit Plans (reformatted 1994)
Not included in this publication

IAS 27 Consolidated and Separate Financial Statements (revised 2004)

IAS 28 Investments in Associates (revised 2004)

IAS 29 Financial Reporting in Hyperinflationary Economies (revised 2003)

IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions (revised 2003)
Not included in this publication

IAS 31 Interests in Joint Ventures (revised 2004)

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IAS 32 Financial Instruments: Disclosure and Presentation (revised 2004)

IAS 33 Earnings per Share (revised 2004)

IAS 34 Interim Financial Reporting (revised 2004)

IAS 36 Impairment of Assets (revised 2004)

IAS 37 Provisions, Contingent Liabilities and Contingent Assets (revised 2004)

IAS 38 Intangible Assets (revised 2004)

IAS 39 Financial Instruments: Recognition and Measurement (revised 2004)

IAS 40 Investment Property (revised 2004)

IAS 41 Agriculture (revised 2004)

IFRS 1 First-time Adoption of IFRSs (revised 2004)

IFRS 2 Share-based Payment (2004)

IFRS 3 Business Combinations (revised 2004)

IFRS 4 Insurance Contracts (2004)

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations (2004)

SIC–7 Introduction of the Euro (revised 2003)

SIC–10 Government Assistance – No Specific Relation to Operating Activities (1998)

SIC–12 Consolidation – Special Purpose Entities (revised 2003)

SIC–13 Jointly Controlled Entities – Non-Monetary Contributions by Venturers (revised 2003)

SIC–15 Operating Leases – Incentives (revised 2003)

SIC–21 Income Taxes – Recovery of Revalued Non-Depreciable Assets (revised 2003)

SIC–25 Income Taxes – Change in the Tax Status of an Enterprise or its Shareholders (revised 2004)

SIC–27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease (revised 2003)

SIC–29 Disclosure – Service Concession Arrangements (revised 2003)
Not included in this publication – no accounting requirements

SIC–31 Revenue – Barter Transactions Involving Advertising Services (revised 2003)

SIC–32 Intangible Assets – Web Site Costs (revised 2004)

IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities (2004)

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