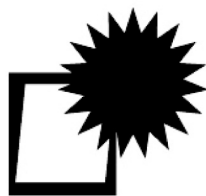


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**2016** Interpretation and  
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**International  
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This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listing their equity or debt securities in the US led, quite naturally, to a call by domestic companies to permit them also to choose freely between financial reporting under US GAAP and IFRS. By late 2008 the SEC appeared to have begun the process of acquiescence, first for the largest companies in those industries having (worldwide) the preponderance of IFRS adopters, and later for all publicly held companies. However, a new SEC chair took office in 2009, expressing a concern that the move to IFRS, if it were to occur, should perhaps take place more slowly than had previously been indicated.

It had been highly probable that non-publicly held US entities would have remained bound to only US GAAP for the foreseeable future, both from habit and because no other set of standards would be viewed as being acceptable. However, the body that oversees the private-sector auditing profession's standards in the US amended its rules in 2008 to fully recognize IASB as an accounting standard-setting body (giving it equal status with the FASB), meaning that auditors and other service providers in the US could now issue opinions (or provide other levels of assurance, as specified under pertinent guidelines) on IFRS-based financial statements. This change, coupled with the promulgation by IASB of a long-sought standard providing simplified financial reporting rules for privately held entities (described later in this chapter), has possibly increased the likelihood that a broad-based move to IFRS will occur in the US within the next several years.

The impetus for the convergence of historically disparate financial reporting standards has been, in the main, to facilitate the free flow of capital so that, for example, investors in the United States will become more willing to finance business in, say, China or the Czech Republic. Having access to financial statements that are written in the same "language" would eliminate what has historically been a major impediment to engendering investor confidence, which is sometimes referred to as "accounting risk," which adds to the more tangible risks of making such cross-border investments. Additionally, the permission to list a company's equity or debt securities on an exchange has generally been conditional on making filings with national regulatory authorities, which have historically insisted either on conformity with local GAAP or on a formal reconciliation to local GAAP. Since these procedures are tedious and time-consuming, and the human resources and technical knowledge to do so are not always widely available, many otherwise anxious would-be registrants forwent the opportunity to broaden their investor bases and potentially lower their costs of capital.

The historic 2002 Norwalk Agreement—between the US standard setter, FASB and the IASB—called for "convergence" of the respective sets of standards, and indeed a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment. The aim of the Boards was to complete the milestone projects of the Memorandum of Understanding (MoU) by the end of June 2011.

Although the Boards were committed to complete the milestone projects by June 2011, certain projects such as financial instruments (impairment and hedge accounting), revenue recognition, leases, and insurance contracts were deferred due to the complexity of the projects and obtaining consensus views. The converged standard on revenue recognition was finally published in May 2014, although FASB has subsequently proposed deferring its effective date and IASB is likely to do the same. Details of these and other projects of the standard setters are included in a separate section in each relevant chapter of this book.

Despite the progress towards convergence described above, the SEC dealt a blow to hopes of future alignment in its strategic plan published in February 2014. The document

states that the SEC “will consider, among other things, whether a single set of high-quality global accounting standards is achievable,” which is a significant reduction in its previously expressed commitment to a single set of global standards. This leaves IFRS and US GAAP as the two comprehensive financial reporting frameworks in the world, with IFRS gaining more and more momentum.

The MoU with FASB (and with other international organizations and also jurisdictional authorities) has been replaced by a MoU with the Accounting Standards Advisory Forum (ASAF). The ASAF is an advisory group to the IASB consisting of national standard setters and regional bodies. FASB’s involvement with the IASB is now through ASAF.

Following the end of the convergence projects, the IASB has started with a new agenda consultation process on the future work program of the IASB. The IASB has started working on its new conceptual framework and included rate-regulated activities as a major project.

## **ORIGINS AND EARLY HISTORY OF THE IASB**

---

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematized form of accounting regulation developed in continental Europe in 1673. Here a requirement for an annual fair value statement of financial position was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic participants was copied by other states and later incorporated in the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon’s efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This “code law” family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on business profits started to be introduced, mostly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual entity and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses that are not financially sound or are run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their (non-management) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialized. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting began to become focused on consolidated accounts and the group, rather than the individual company. For differing reasons, neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and

in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

The second model of financial reporting, generally regarded as the Anglo-Saxon financial reporting approach, can be characterized as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC's mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed at the investor, not the government.

Neither of the two above-described approaches to financial reporting is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonized by industrialized nations) they have adopted variants of one or the other of these two models.

IFRS are an example of the second, capital market-oriented, systems of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC) was formed in 1973, during a period of considerable change in accounting regulation. In the US the Financial Accounting Standards Board (FASB) had just been created, in the UK the first national standard setter had recently been organized, the EU was working on the main plank of its own accounting harmonization plan (the Fourth Directive), and both the UN and the OECD were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (Institute of Chartered Accountants in England and Wales—ICAEW) and the American profession (American Institute of Certified Public Accountants—AICPA). A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands, and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to make it a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

IASC's efforts entered a new phase in 1987, which led directly to its 2001 reorganization, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was interested in identifying a common international "passport" whereby companies could be accepted for secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to endorse IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to a quality and comprehensiveness level that IOSCO stipulated.

Historically, a major criticism of IFRS had been that it essentially endorsed all the accounting methods then in wide use, effectively becoming a "lowest common denominator"

set of standards. The trend in national GAAP had been to narrow the range of acceptable alternatives, although uniformity in accounting had not been anticipated as a near-term result. The IOSCO agreement energized IASC to improve the existing standards by removing the many alternative treatments that were then permitted under the standards, thereby improving comparability across reporting entities. The IASC launched its Comparability and Improvements Project with the goal of developing a “core set of standards” that would satisfy IOSCO. These were complete by 1993, not without difficulties and spirited disagreements among the members, but then—to the great frustration of the IASC—these were not accepted by IOSCO. Rather than endorsing the standard-setting process of IASC, as was hoped for, IOSCO seemingly wanted to cherry-pick individual standards. Such a process could not realistically result in near-term endorsement of IFRS for cross-border securities registrations.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further period of frenetic activities, where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps in IFRS. This time the set of standards included, among others, IAS 39, on recognition and measurement of financial instruments, which was endorsed, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the same time, the IASC had undertaken an effort to consider its future structure. In part, this was the result of pressure exerted by the US SEC and also by the US private sector standard setter, the FASB, which were seemingly concerned that IFRS were not being developed by “due process.” While the various parties may have had their own agendas, in fact the IFRS were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events. The challenges presented to IASC ultimately would serve to make IFRS stronger.

If IASC was to be the standard setter endorsed by the world’s stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but possibly where national standard setters appointed representatives—or a small, professional body of experienced standard setters which worked independently of national interests.

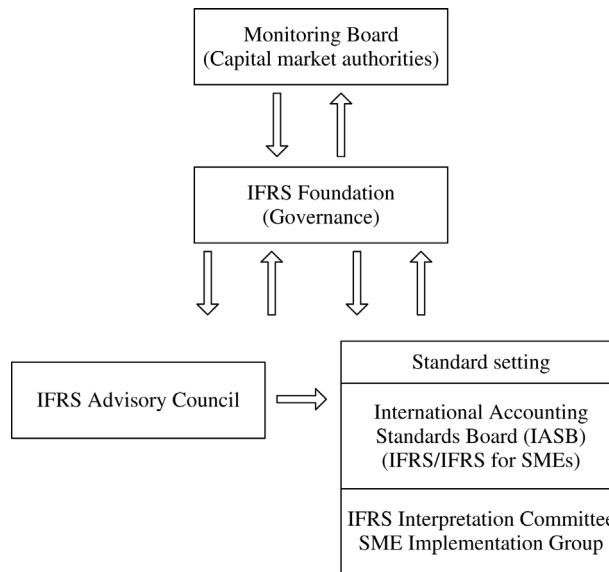
The end of this phase of international standard setting, and the resolution of these issues, came about within a short period in 2000. In May of that year, IOSCO members voted to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which itself was quickly exceeded by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the European Union (EU) eclipsed the lukewarm IOSCO approval, and since then the EU has appeared to be the more influential body insofar as gaining acceptance for IFRS has been concerned. Indeed, the once-important IOSCO endorsement has become of little importance given subsequent developments, including the EU mandate and convergence efforts among several standard-setting bodies.

In July 2000, IASC members voted to abandon the organization’s former structure, which was based on professional bodies, and adopt a new structure: beginning in 2001,

standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

## THE CURRENT STRUCTURE

The formal structure put in place in 2000 has the IFRS Foundation, a Delaware corporation, as its keystone (this was previously known as the IASC Foundation). The Trustees of the IFRS Foundation have both the responsibility to raise funds needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the International Financial Reporting Interpretations Committee (IFRIC) and the IFRS Advisory Council (AC). The structure changed by incorporating the Monitoring Board in 2009, renaming and incorporating the SME Implementation Group in 2010 as follows:



The Monitoring Board is responsible for ensuring that the Trustees of the IFRS Foundation discharge their duties as defined by the IFRS Foundation Constitution and for approving the appointment or reappointment of Trustees. The Monitoring Board consists of the Emerging Markets and Technical Committees of the International Organization of Securities Commissions (IOSCO), the European Commission, the Financial Services Agency of Japan (JFSA), and US Securities and Exchange Commission (SEC). The Basel Committee on Banking Supervision currently only participates as an observer.

The IFRS Foundation is governed by trustees and reports to the Monitoring Board. The IFRS Foundation has fundraising responsibilities and oversees the standard-setting work, the IFRS structure and strategy. It is also responsible for the review of the Constitution.

The IFRS Advisory Council (formerly the SAC) is the formal advisory body to the IASB and the Trustees of the IFRS Foundation. Members consist of user groups, preparers,



financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups.

The IASB is an independent body that is solely responsible for establishing International Financial Reporting Standards (IFRS), including IFRS for SMEs. The IASB also approves new interpretations.

The International Financial Reporting Interpretations Committee (IFRIC) is a committee comprised mostly of technical partners in audit firms but also includes preparers and users. IFRIC's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different rules. In recent times it has also proposed modifications to standards to the IASB, in response to perceived operational difficulties or the need to improve consistency. IFRIC liaises with the US Emerging Issues Task Force and similar bodies and standard setters to try to preserve convergence at the level of interpretation.

Working relationships are set up with local standard setters who have adopted or converged with International Financial Reporting Standards (IFRS), or are in the process of adopting or converging with IFRS. The statement of working relationship sets out a range of activities that should be undertaken to facilitate the adoption and use of IFRS.

## PROCESS OF IFRS STANDARD SETTING

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The IASB has a formal due process, which is currently set out in the *IASB and IFRS Interpretation Committee Due Process Handbook of the IASB* issued in February 2013.

At a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis. The IFRS Foundation has a committee, the Trustees' Due Process Oversight Committee, which regularly reviews and updates the due process.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the IFRS Advisory Council, liaison standard setters, the international audit firms, and others. These are debated by IASB and tentative conclusions are discussed with the various consultative bodies. The IASB also has a joint agenda committee with the FASB. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by IASB in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper which is then debated at a subsequent meeting. In theory there is an internal process where the staff proposes solutions, and IASB either accepts or rejects them. In practice the process is more involved: sometimes (especially for projects such as financial instruments) individual Board members are delegated special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one thing or another.

The due process comprises six stages: (1) setting the agenda; (2) project planning; (3) developing and publishing a discussion paper; (4) developing and publishing an Exposure Draft; (5) developing and publishing the IFRS; and (6) procedures after an IFRS is issued. The process also includes discussion of Staff Papers outlining the principal issues and analysis of comments received on Discussion Papers and Exposure Drafts. A pre-ballot draft is normally subject to external review. A near final draft is also posted on the limited access website. If all outstanding matters are resolved, the final ballot is applied.

Final ballots on the standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB website and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where IASB takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. The Board may decide not to issue Discussion Papers or to reissue Discussion Papers and Exposure Drafts.

The IASB also has regular public meetings with the Analyst Representative Group (ARG) and the Global Preparers Forum (GPF), among others. Special groups such as the Financial Crisis Advisory Group are set up from time to time. Formal working groups are established for certain major projects to provide additional practical input and expertise. Apart from these formal consultative processes, IASB also carries out field trials of some standards (examples of this include performance reporting and insurance), where volunteer preparers apply the proposed new standards. The IASB may also hold some form of public consultation during the process, such as roundtable discussions. The IASB engages closely with stakeholders around the world such as investors, analysts, regulators, business leaders, accounting standard setters and the accountancy profession.

The revised *IASB and IFRS Interpretations Committee Due Process Handbook* has an introduction section dealing with oversight, which identifies the responsibilities of the Due Process Oversight Committee. The work of the IASB is divided into development and maintenance projects. Developments are comprehensive projects such as major changes and new IFRSs. Maintenance is narrow scope amendments. A research program is also described that should form the development base for comprehensive projects. Each phase of a major project should also include an effects analysis detailing the likely cost and benefits of the project.

## **CONVERGENCE: THE IASB AND FINANCIAL REPORTING IN THE US**

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Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only then that FASB became interested in IASC, when IASC was beginning to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to consider the international financial reporting area, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO's efforts to create a single passport for secondary listings, and IASC's role as its standard setter, while intended to operate worldwide, would have the greatest practical significance for foreign issuers in terms of the US market. It was understood that if the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US capital markets by foreign registrants would be greatly

facilitated. The SEC has therefore been a key factor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987, and also observed that too many options for diverse accounting were available under IAS. SEC suggested that it would be more favourably inclined to consider acceptance of IAS (now IFRS) if some or all of these alternatives were reduced. Shortly after IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) to the effect that, to be acceptable, IFRS would need to satisfy the following three criteria:

1. It would need to establish a core set of standards that constituted a comprehensive basis of accounting;
2. The standards would need to be of high quality, and would enable investors to analyse performance meaningfully both across time periods and among different companies; and
3. The standards would have to be rigorously interpreted and applied, as otherwise comparability and transparency could not be achieved.

IASC's plan was predicated on its completion of a core set of standards, which would then be handed over to IOSCO, which in turn would ask its members for an evaluation, after which IOSCO would issue its verdict as to acceptability. It was against this backdrop that the SEC issued a "concept release" in 2000, that solicited comments regarding the acceptability of the core set of standards, and whether there appeared to be a sufficiently robust compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, whether auditors would ensure this, and whether stock exchange regulators would verify such compliance.

This last-named element remains beyond the control of IASB, and is within the domain of national compliance bodies or professional organizations in each jurisdiction. The IASC's Standards Interpretations Committee (SIC, which was later succeeded by IFRIC) was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to establish liaison channels with stock exchange regulators and national interpretations bodies—but the predominant responsibilities remain in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies.

The SEC's stance at the time was that it genuinely wanted to see IFRS used by foreign registrants, but that it preferred convergence (so that no reconciliation would be necessary) over the acceptance of IFRS as they were in 2000 without reconciliation. In the years since, the SEC has in many public pronouncements supported convergence and, as promised, waived reconciliations in 2008 for registrants fully complying with IFRS. Thus, for example, the SEC welcomed various proposed changes to US GAAP to converge with IFRS.

Relations between FASB and IASB have grown warmer since IASB was restructured, perhaps influenced by the growing awareness that IASB would assume a commanding position in the financial reporting standard-setting domain. The FASB had joined the IASB for informal meetings as long ago as the early 1990s, culminating in the creation of the G4+1 group of Anglophone standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer), in which FASB was an active participant. Perhaps the most significant event was when IASB and FASB signed the Norwalk Agreement in October 2002, which set out a program for the convergence of their respective sets of financial reporting standards. The organizations' staffs have worked together on a number of vital projects, including business combinations and revenue recognition, since the Agreement was signed and, later, supplemented by the 2006 and 2008 Memorandum of Understandings (MoU)

between these bodies. The two Boards have a joint agenda committee whose aim is to harmonize the timing with which the boards discuss the same subjects. The Boards are also committed to meeting twice a year in joint session.

In June 2010 the Boards announced a modification to their convergence strategy, responding to concerns from some stakeholders regarding the volume of draft standards due for publication in close proximity. The strategy retained the June 2011 target date to complete those projects for which the need for improvement was the most urgent. In line with this strategy, the Boards completed the consolidation (including joint arrangements) and fair value measurement project before the June 2011 target date. The derecognition project was cancelled and only disclosure amendments were incorporated in the standard. Projects on financial instruments, leases, revenue, and insurance contracts were extended to create significant time for reconsultation after comments were received.

With the end of the MoU with FASB, FASB has become a member of ASAF similarly to other standard setters. The remaining outstanding MoU projects were thus completed as IASB projects and not joint projects.

However, certain convergence problems remain, largely of the structural variety. FASB operates within a specific national legal framework, while IASB does not. Equally, both have what they term “inherited” GAAP (i.e., differences in approach that have a long history and are not easily resolved). FASB also has a tradition of issuing very detailed, prescriptive (“rules-based”) standards that give bright-line accounting (and, consequently, audit) guidance, which are intended to make compliance control easier and remove uncertainties. Notwithstanding that detailed rules had been ardently sought by preparers and auditors alike for many decades, in the post-Enron world, after it became clear that some of these highly prescriptive rules had been abused, interest turned toward developing standards that would rely more on the expression of broad financial reporting objectives, with far less detailed instruction on how to achieve them (“principles-based” standards). This was seen as being superior to the US GAAP approach, which mandated an inevitably doomed effort to prescribe responses to every conceivable fact pattern to be confronted by preparers and auditors.

This exaggerated rules-based vs. principles-based dichotomy was invoked particularly following the frauds at US-based companies WorldCom and Enron, but before some of the more prominent European frauds, such as Parmalat (Italy) and Royal Ahold (the Netherlands) came to light, which would suggest that neither the use of US GAAP nor IFRS could protect against the perpetration of financial reporting frauds if auditors were derelict in the performance of their duties or even, on rare occasions, complicit in management’s frauds. As an SEC study (which had been mandated by the Sarbanes-Oxley Act of 2002) into principles-based standards later observed, use of principles alone, without detailed guidance, reduces comparability. The litigious environment in the US also makes companies and auditors reluctant to step into areas where judgements have to be taken in uncertain conditions. The SEC’s solution: “objectives-based” standards that are both soundly based on principles and inclusive of practical guidance.

Events in the mid- to late-2000s served to accelerate the pressure for full convergence between US GAAP and IFRS. In fact, the US SEC’s decision in late 2007 to waive reconciliation requirements for foreign registrants complying with “full IFRS” was a clear indicator that the outright adoption of IFRS in the US could be on the horizon, and that the convergence process might be made essentially redundant if not actually irrelevant. The SEC has since granted qualifying US registrants (major players in industry segments, the majority

of whose worldwide participants already report under IFRS) the limited right to begin reporting under IFRS in 2009.

In late 2008, the SEC proposed its so-called “roadmap” for a phased-in IFRS adoption, setting forth four milestones that, if met, could have led to wide-scale adoption beginning in 2014. However, under the new leadership, which assumed office in 2009, the SEC has shown that it will act with less urgency on this issue, and achievement of the “milestones”—which include a number of subjective measures such as improvement in standards and level of IFRS training and awareness among US accountants and auditors—leaves room for later balking at making the final commitment to IFRS. Notwithstanding these impediments to progress, the authors believe that there is ultimately an inexorable move toward universal adoption of IFRS, and that the leading academic and public accounting (auditing) organizations must, and will, take the necessary steps to ensure that this can move forward. For example, in the US the principal organization of academicians is actively working on standards for IFRS-based accounting curricula, and the main organization representing independent accountants is producing Web-based materials and live conferences to educate practitioners about IFRS matters.

While the anticipated further actions by the US SEC will only directly promote or require IFRS adoption by multinational and other larger, publicly held business entities, and later by even small, publicly held companies, in the longer run, even medium- and smaller-sized entities will probably opt for IFRS-based financial reporting. There are several reasons to predict this “trickle down” effect. First, because some involvement in international trade is increasingly a characteristic of all business operations, the need to communicate with customers, creditors, and potential partners or investors will serve to motivate “one language” financial reporting. Second, the notion of reporting under “second-class GAAP” rather than under the standards employed by larger competitors will eventually prove to be unappealing. And thirdly, IASB’s issuance of a one-document comprehensive standard on financial reporting by entities having no public reporting responsibilities (IFRS for SMEs, discussed later in this chapter), coupled with formal recognition under US auditing standards that financial reporting rules established by IASB are a basis for an expression of an auditor’s professional opinion, may actually find enthusiastic support among smaller US reporting entities and their professional services providers, even without immediate adoptions among publicly held companies.

## **THE IASB AND EUROPE**

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Although France, Germany, the Netherlands and the UK were founding members of predecessor organization the IASC and have remained heavily involved with IASB, the European Commission (EC) as such has generally had a fitful relationship with the international standard setter. The EC did not participate in any way until 1990, when it finally became an observer at Board meetings. It had had its own regional program of harmonization since the 1960s and in effect only officially abandoned this in 1995, when, in a policy paper, it recommended to member states that they seek to align their rules for consolidated financial statements on IFRS. Notwithstanding this, the Commission gave IASB a great boost when it announced in June 2000 that it wanted to require all listed companies throughout the EU to use IFRS beginning in 2005 as part of its initiative to build a single European financial market. This intention was made concrete with the approval of the IFRS Regulation in June 2002 by the European Council of Ministers (the supreme EU decision-making authority).

The EU decision was all the more welcome given that, to be effective in legal terms, IFRS have to be enshrined in EU statute law, creating a situation where the EU is in effect ratifying as laws the set of rules created by a small, self-appointed, private-sector body. This proved to be a delicate situation, which was revealed within a very short time to contain the seeds of unending disagreements, as politicians were being asked in effect to endorse something over which they had no control. They were soon being lobbied by corporate interests that had failed to effectively influence IASB directly, in order to achieve their objectives, which in some cases involved continued lack of transparency regarding certain types of transactions or economic effects, such as fair value changes affecting holdings of financial instruments. The process of obtaining EU endorsement of IFRS was at the cost of exposing IASB to political pressures in much the same way that the US FASB has at times been the target of congressional manipulations (e.g., over stock-based compensation accounting rules in the mid-1990s, the derailing of which arguably contributed to the practices that led to various backdating abuse allegations made in more recent years).

The EU created an elaborate machinery to mediate its relations with IASB. It preferred to work with another private-sector body, created for the purpose, the European Financial Reporting Advisory Group (EFRAG), as the formal conduit for EU inputs to IASB. EFRAG was formed in 2001 by a collection of European representative organizations (for details see [www.efrag.org](http://www.efrag.org)), including the European Accounting Federation (FEE) and a European employer organization (BUSINESSEUROPE). EFRAG in turn formed the small Technical Expert Group (TEG) that does the detailed work on IASB proposals. EFRAG consults widely within the EU, and particularly with national standard setters and the European Commission to canvass views on IASB proposals, and provides input to IASB. It responds formally to all discussion papers and Exposure Drafts.

At a second stage, when a final standard is issued, EFRAG is asked by the Commission to provide a report on the standard. This report is to state whether the standard has the requisite quality and is in conformity with European company law directives. The European Commission then asks another entity, the Accounting Regulatory Committee (ARC), whether it wishes to endorse the standard. ARC consists of permanent representatives of the EU member state governments. It should normally only fail to endorse IFRS if it believes they are not in conformity with the overall framework of EU law, and should not take a strategic or policy view. However, the European Parliament also has the right to independently comment, if it so wishes. If ARC fails to endorse a standard, the European Commission may still ask the Council of Ministers to override that decision.

Experience has shown that the system suffers from a number of problems. First, although EFRAG is intended to enhance EU inputs to IASB, it may in fact isolate people from IASB, or at least increase the costs of making representations. For example, when IASB revealed its intention to issue a standard on stock options, it received nearly a hundred comment letters from US companies (who report under US GAAP, not IFRS), but only one from EFRAG, which in the early 2000s effectively represented about 90% of IASB's constituents. It is possible, however, that EFRAG is seen at IASB as being only a single respondent, and if so, that people who have made the effort to work through EFRAG feel underrepresented. In addition, EFRAG inevitably will present a distillation of views, so it is already filtering respondents' views before they even reach IASB. The only recourse is for respondents to make representations not only to EFRAG but also directly to IASB.

However, resistance to the financial instruments standards, IAS 32 and IAS 39, put the system under specific strain. These standards were already in existence when the European

Commission announced its decision to adopt IFRS for European listed companies, and they had each been exhaustively debated before enactment. European adoption again exposed these particular standards to strenuous debate.

The first task of EFRAG and ARC was to endorse the existing standards of IASB. They did this—but excluded IAS 32 and 39 on the grounds that they were being extensively revised as part of IASB’s then-ongoing *Improvements Project*.

During the exposure period of the improvements proposals—which exceptionally included roundtable meetings with constituents—the European Banking Federation, under particular pressure from French banks, lobbied IASB to modify the standard to permit special accounting for macrohedging. The IASB agreed to do this, even though that meant the issuance of another Exposure Draft and a further amendment to IAS 39 (which was finally issued in March 2004). The bankers did not like the terms of the amendment, and even as it was still under discussion, they appealed to the French president and persuaded him to intervene. He wrote to the European Commission in July 2003, saying that the financial instruments standards were likely to cause banks’ reported earnings to be more volatile and would destabilize the European economy, and thus that the proposed standard should not be approved. He also argued that the Commission did not have sufficient input to the standard-setting process.

This drive to alter the requirements of IAS 39 was intensified when the European Central Bank complained in February 2004 that the “fair value option,” introduced to IAS 39 as an improvement in final form in December 2003, could be used by banks to manipulate their *prudential ratios* (the capital to assets ratios used to evaluate bank safety), and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although this meant issuing another Exposure Draft and a further amendment to IAS 39 which was not finalized until mid-2005. When IASB debated the issue, it took a pragmatic line that no compromise of principle was involved, and that it was reasonable that the principal bank regulator of the Board’s largest constituent by far should be accommodated. The fact that the European Central Bank had not raised these issues at the original Exposure Draft stage was not discussed, nor was the legitimacy of a constituent deciding unilaterally it wanted to change a rule that had just been approved. The Accounting Standards Board of Japan lodged a formal protest, and many other constituents were not pleased at this development.

Ultimately, ARC approved IAS 32 and IAS 39, but a “carve out” from IAS 39 was prescribed. Clearly the EU’s involvement with IFRS is proving to be a mixed blessing for IASB, both exposing it to political pressures that are properly an issue for the Commission, not IASB, and putting its due process under stress. Some commentators speculated that the EU might even abandon IFRS, but this is not a realistic possibility, given the worldwide movement toward IFRS and the fact that the EU had already tried and rejected the regional standard-setting route.

A better observation is that this is merely part of a period of adjustment, with regulators and lobbyists both being uncertain as to how exactly the system does and should work, and both testing its limits, but with some *modus vivendi* evolving over time. However, it is severe distraction for IASB that financial instruments, arguably the area of greatest accounting controversy in the 1990s, is one that is still causing concern to the present date, in part exacerbated by the worldwide financial crisis of 2007–2009. Some believe that financial instruments accounting issues should have been fully resolved years ago, so that IASB could give its undivided attention to such crucial topics as revenue recognition, performance reporting and insurance contracts.

The EC decision to impose “carve-outs” has most recently had the result that the US SEC’s historic decision to eliminate reconciliation to US GAAP for foreign private issuers has been restricted to those registrants that file financial statements that comply with “full IFRS” (which implies that those using “Euro-IFRS” and other national modifications of IFRS promulgated by the IASB will not be eligible for this benefit). Registrants using any deviation from pure IFRS, and those using any other national GAAP, will continue to be required to present a reconciliation to US GAAP. Over time, it can be assumed that this will add to the pressure to report under “full IFRS,” and that even the EU may line up behind full and complete adherence to officially promulgated IFRS. In November 2009 the EFRAG decided to defer the endorsement of IFRS 9, although in principle they agree with the management approach adopted in IFRS 9. This deferral remains in place at the time of writing in June 2015. The EFRAG believe that more time should be taken to consider the outcome of other sections of the financial instrument project and that the sections should be endorsed as a package.

In June 2010 the EFRAG issued a new *Strategy for European Proactive Financial Reporting Activities*. This strategy of proactive activities enhances EFRAG’s role in influencing standard setting by early engagement with European constituents to provide effective and timely input to the IASB’s work. This demonstrates that EFRAG is positively committed to the standard-setting process and it has duly become a member of ASAF.

## IFRS FOR SMEs

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The *IFRS for SMEs* was originally issued by the IASB in July 2009 to reduce the financial reporting burden of small and medium-sized entities. In the process, many of the recognition and measurement principles in full IFRS have been simplified, disclosures significantly reduced and topics not relevant to SMEs omitted. Appendix C attached to this chapter provides discussion of these differences. The IASB has carried out a comprehensive review of the *IFRS for SMEs* which it completed in May 2015 and has published a list of amendments. It intends issuing a complete revised version of the standard during the third quarter of 2015. On an ongoing basis the IASB expects that revisions to the standard will be limited to once every three years.

The standard is a stand-alone document with only one optional cross-reference to full IFRS for financial instruments, which provides a choice regarding the treatment of financial instruments. The standard is appropriate for general-purpose financial statements. General-purpose financial statements are directed towards the common information needs of a wide range of users, for example, shareholders, creditors, employees, and the public at large.

*IFRS for SMEs* is intended for entities that do not have public accountability. An entity has public accountability—and therefore would not be permitted to use the *IFRS for SMEs*—if it meets either of the following conditions: (1) it has issued debt or equity securities in a public market; or (2) it holds assets in a fiduciary capacity, as one of its primary businesses, for a broad group of outsiders. The latter category of entity would include most banks, insurance companies, securities broker/dealers, pension funds, mutual funds, and investment banks.

The responsibility lies with each jurisdiction to determine which entities should apply the *IFRS for SMEs*. Comprehensive training material has been developed for SMEs by the IFRS



Foundation and a SME Implementation Group exists to deal with financial reporting issues regarding SMEs.

The application of the *IFRS for SMEs* standard has not been covered in this publication. However, there is a detailed accounting manual available that addresses the requirements, application, and interpretation of this standard—*Applying IFRS for SMEs* (available from Wiley).

## **APPENDIX A: CURRENT INTERNATIONAL FINANCIAL REPORTING STANDARDS (IAS/IFRS) AND INTERPRETATIONS (SIC/IFRIC)**

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IFRS 1	First-Time Adoption of IFRS
IFRS 2	Share-Based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interest in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related-Party Disclosure
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairments of Assets
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets

IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4	Determining whether an Arrangement contains a Lease
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, <i>Financial Reporting in Hyperinflationary Economies</i>
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programs
IFRIC 14	IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and Their Interaction
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-cash Assets to Owners
IFRIC 18	Transfer of Assets from Customers
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21	Levies
SIC 7	Introduction of the Euro
SIC 10	Government Assistance—No Specific Relation to Operating Activities
SIC 15	Operating Leases—Incentives
SIC 25	Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders
SIC 27	Evaluating the Substance of Transactions involving the Legal Form of a Lease
SIC 29	Disclosure—Service Concession Arrangements
SIC 31	Revenue—Barter Transactions Involving Advertising Services
SIC 32	Intangible Assets—Web Site Costs

## APPENDIX B: PROJECTS COMPLETED SINCE PREVIOUS ISSUE (JULY 2014 TO JUNE 2015)

Project	Issue date	Nature	Effective date
IFRS 15 Revenue from Contracts with Customers	May 2014	Clarification on principles of revenue recognition	January 1, 2017 (NB In May 2015 the IASB published an Exposure Draft proposing a one-year deferral of the effective date of IFRS 15 to 1 January 2018. The comment period for this Exposure Draft ended on 3 July 2015.) January 1, 2018
IFRS 9 Financial Instruments	July 2014	Final phase of project to replace IAS 39	January 1, 2018
Equity Method in Separate Financial Statements (Amendments to IAS 27)	August 2014	To restore the option to use the equity method of accounting in separate financial statements.	January 1, 2016
Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Amendments to IFRS 10 and IAS 28)	September 2014	To address an acknowledged inconsistency between the requirements in IFRS 10 and IAS 28.	January 1, 2016
Annual Improvements 2012–2014	September 2014	Small amendments to multiple standards.	January 1, 2016
Investment Entities: Applying the Consolidated Exception (amendments to IFRS 10, IFRS 12 and IAS 28)	December 2014	To clarify: which subsidiaries of an investment entity are consolidated in accordance with paragraph 32 of IFRS 10; the exemption from preparing consolidated financial statements for an indeterminate parent of an investment entity; and application of the equity method by a non-investment entity investor to an investment entity investee.	January 1, 2016
Disclosure initiative (Amendments to IAS 1)	December 2014	To address overly prescriptive interpretations of the wording in IAS 1.	January 1, 2016

## APPENDIX C: IFRS FOR SMEs

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A long-standing debate among professional accountants, users and preparers—between those advocating for some form of simplified financial reporting standards for (variously defined) smaller or non-publicly responsible entities, and those arguing that all reporting entities purporting to adhere to officially mandated accounting standards do so with absolute faithfulness—has now been resolved. On July 9, 2009, IASB published the *International Financial Reporting Standard (IFRS) for Small and Medium-Sized Entities (IFRS for SMEs)*. Notwithstanding the name, it is actually intended as an optional, somewhat simplified and choice-limited comprehensive financial reporting standard for enterprises not having public accountability.

A parallel debate raged in the UK, the US, and in other national GAAP domains for decades. In the US a number of inchoate proposals have been offered over at least the past 30 years, but no serious proposal was forthcoming, largely because the idea of differential recognition or measurement standards for smaller entities was seen as conceptually unappealing, leaving the relatively trivial issue of differential disclosures as the focus of discussion. Apart from a limited number of disclosure topics, such as segment results and earnings per share, and some pension obligation details, this proved not to be a very productive line of inquiry, and no sweeping changes were ever adopted or even proposed.

In the UK, the story was different. A single, comprehensive standard, the *Financial Reporting Standard for Smaller Entities (FRSSE)*, was successfully implemented over a decade ago, and then revised several times, employing a periodic updating strategy that IASB has now emulated. Rather than impose different recognition or measurement concepts on smaller entities, the approach taken, in the main, was to slim down the standards, eliminate much of the background and illustrative materials, and in some cases narrow or eliminate the alternative methods that users of full UK GAAP could elect to apply, with some concomitant simplifications to informative disclosures. Since this was deemed to have been successful in the UK, IASB determined to emulate it, beginning with a Discussion Paper in 2004, and continuing through an early-2007 Exposure Draft and a final standard in mid-2009.

In August 2009 the UK Accounting Standards Board (ASB) issued a consultation paper to adopt *IFRS for SMEs* in the UK. Good support was received to adopt a standard based on the *IFRS for SMEs* as a second-tier standard. *FRSSE* should be retained as an interim measure for third-tier standard. The process culminated in the issue, in March 2013, of FRS 102 *The Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland*, a standard based on *IFRS for SMEs* which will apply to second-tier entities with effect from accounting periods commencing on or after January 1, 2015.

The enthusiasm and support that was shown for the *IFRS for SMEs* project from national accounting standard setters throughout the world stemmed mostly from the widely acknowledged complexity of the full body of IFRS, and from the different statutory requirements for financial reporting in many countries, which in many instances demand that audited financial statements, without any qualifications, be submitted to tax or other authorities. For example, in the European Union about 7,000 listed companies were implementing IFRS in 2005, but more than 5 million SMEs are required to prepare their financial statements in accordance with various national GAAP, resulting in lack of comparability across this sector of financial reporting entities. Reportedly, more than 50 different sets of standards govern private reporting in the 27 EU nations. EFRAG has not

decided whether the *IFRS for SMEs* should be endorsed in Europe, although most countries have responded positively to such an implementation.

It had long been asserted, although often without solid evidence, that the complexity of the full body of IFRS (and, even more so, of full US GAAP) imposes a high and unwelcome cost on implementing and applying these standards, and that many or most external users of the resulting financial statements did not see value commensurate with the cost and effort associated with their preparation. Whether or not this is true, many now believe that *IFRS for SMEs* will provide companies with an easier transition to the full IFRS, thus serving to accomplish, in the longer term, a more thorough and broadly based move toward universal reporting under a single set of financial reporting standards.

Opponents of a separate set of standards for SMEs believe that all entities should follow the same basic set of accounting principles for the preparation of general-purpose financial statements, whether that set of standards be IFRS or US GAAP. Some have noted that complexity in accounting is merely a symptom—the inevitable result of the ever-increasing complexity of transactional structures, such as the widespread use of “engineered” financial products. Based on observations of the difficulties faced by companies implementing and applying the full IFRS, others have concluded that the problem is not that SMEs need simpler accounting, but that all reporting entities would benefit from reporting requirements that are less complex and more principles-based. Since this latter goal seemed to be perpetually unattainable, momentum ultimately shifted in favour of having a simplified stand-alone standard for either smaller or non-public companies. *IFRS for SMEs*, available for use by non-publicly accountable entities of any size, is the solution that has been rendered by IASB to this chronic problem.

Because the IASB lacks the power to require any company to use its standards, the adoption of *IFRS for SMEs* is a matter for each country to decide. The issue must be resolved by a country’s government legislators and regulators, or by an independent standards setter, or by a professional accountancy body. Each country will need to establish criteria to determine eligibility of reporting entities seeking to qualify under this new standard as a “small or medium-sized” entity.

The *IFRS for SMEs* is not immediately updated for any changes to full IFRS but, as noted above, the IASB has issued amendments in the first half of 2015 and then anticipates updating the standard every three years thereafter.

### **Definition of SMEs**

*IFRS for SMEs* is intended for entities that do not have public accountability. An entity has public accountability—and therefore would not be permitted to use *IFRS for SMEs*—if it meets either of the following conditions: (1) it has issued debt or equity securities in a public market; or (2) it holds assets in a fiduciary capacity, as one of its primary businesses, for a broad group of outsiders. The latter category of entity would include most banks, insurance companies, securities broker/dealers, pension funds, mutual funds, and investment banks. The standard does not impose a size test in defining SMEs, notwithstanding the nomenclature used.

The standard also states that it is intended for entities that publish financial statements for external users; as with IFRS and US GAAP, in other words, the standard is not intended to govern internal or managerial reporting (although there is nothing to prevent such reporting from fully conforming to such standards).

A subsidiary of an entity that employs full IFRS, or an entity that is part of a consolidated entity that reports in compliance with IFRS may report, on a stand-alone basis, in accordance with *IFRS for SMEs*, if the financial statements are so identified, and if the subsidiary does not have public accountability itself. If this is done, the standard must be fully complied with, which could mean that the subsidiary's stand-alone financial statements would differ from how they are presented within the parent's consolidated financial statements; for example, in the subsidiary's financial statements prepared in accordance with *IFRS for SMEs*, borrowing costs incurred in connection with construction of long-lived assets would be expensed as incurred, but those same borrowing costs would be capitalized in the consolidated financial statements, since IAS 23 as most recently revised no longer provides the option of immediate expensing. In the authors' view, this would not be optimal financial reporting, and the goals of consistency and comparability would be better served if the stand-alone financial statements of the subsidiary also were based on full IFRS.

### ***IFRS for SMEs* is a Complete, Self-Contained Set of Requirements**

*IFRS for SMEs* is a complete and comprehensive standard, and accordingly contains much or most of the vital guidance provided by the full IFRS. For example, it defines the qualities that are needed for IFRS-compliant financial reporting (reliability, understandability, et al.), the elements of financial statements (assets, liabilities, et al.), the required minimum captions in the required full set of financial statements, the mandate for comparative reporting, and so forth. There is no need for an entity reporting under this standard to refer elsewhere (other than for guidance in IAS 39, discussed below), and indeed it would be improper to do so.

An entity having no public accountability that elects to report in conformity with *IFRS for SMEs* must make an "explicit and unreserved" declaration to that effect in the notes to the financial statements. As with a representation that the financial statements comply with (full) IFRS, if this representation is made, the entity must comply fully with all relevant requirements in the standard(s).

Many options under full IFRS remain under *IFRS for SMEs*. For example, a single statement of comprehensive income can be presented, with profit or loss being an intermediate step in the derivation of the period's comprehensive income or loss, or alternatively a separate statement of income can be displayed, with profit or loss (the "bottom line" in that statement) then being the opening item in the separate statement of comprehensive income. Likewise, most of the mandates under full IFRS, such as the need to consolidate special-purpose entities that are controlled by the reporting entity, also exist under *IFRS for SMEs*.

### **Modifications of Full IFRS Made for *IFRS for SMEs***

Compared to the full IFRS, the aggregate length of the standards, in terms of number of words, has been reduced by more than 90%. This was achieved by eliminating topics deemed not to be generally relevant to SMEs, by eliminating certain choices of accounting treatments, and by simplifying methods for recognition and measurement. These three sets of modifications to the content of the full IFRS, which are discussed below, respond to both the perceived needs of users of SMEs' financial statements and to cost-benefit concerns. According to the IASB, the set of standards in the *IFRS for SMEs* will be suitable for a typical enterprise having 50 employees, and will also be valid for so-called micro-entities having only a single or a few employees. However, no size limits are stipulated in the standard, and thus even very large entities could conceivably elect to apply *IFRS for SMEs*,

assuming they have no public accountability as defined in the standard, and that no objections are raised by their various other stakeholders, such as lenders, customers, vendors, or joint venture partners.

**Omitted topics.** Certain topics covered in the full IFRS were viewed as not being relevant to typical SMEs (e.g., rules pertaining to transactions that were thought to be unlikely to occur in an SME context), and have accordingly been omitted from the standard. This leaves open the question of whether SMEs could optionally seek expanded guidance in the full IFRS. Originally, when the Exposure Draft of *IFRS for SMEs* was released, cross-references to the full IFRS were retained, so that SMEs would not be precluded from applying any of the financial reporting standards and methods found in IFRS, essentially making the *IFRS for SMEs* standard entirely optional on a component-by-component basis. However, in the final *IFRS for SMEs* standard all of these cross-references have been removed, with the exception of a reference to IAS 39, *Financial Instruments: Recognition and Measurement*, thus making *IFRS for SMEs* a fully stand-alone document, not to be used in conjunction with the full IFRS. An entity that would qualify for use of *IFRS for SMEs* must therefore make a decision to use full IFRS or *IFRS for SMEs* exclusively.

Topics addressed in the full IFRS that are entirely omitted from the IFRS for SME standard are as follows:

- Earnings per share;
- Interim reporting;
- Segment reporting;
- Special accounting for assets held for sale;
- Insurance (since, because of public accountability, such entities would be precluded from using *IFRS for SMEs* in any event).

Thus, for example, if a reporting entity concluded that its stakeholders wanted presentation of segment reporting information, and the entity's management wished to provide that to them, it would elect to prepare financial statements in conformity with the full set of IFRS, eschewing use of *IFRS for SMEs*.

**Only the simpler option included.** Where full IFRS provide an accounting policy choice, generally only the simpler option is included in *IFRS for SMEs*. SMEs will not be permitted to employ the other option(s) provided by the full IFRS, as had been envisioned by the Exposure Draft that preceded this standard, as all cross-references to the full IFRS have been eliminated.

The simpler options selected for inclusion in *IFRS for SMEs* are as follows, with the excluded alternatives noted:

- For investment property, measurement is driven by circumstances rather than a choice between the cost and fair value models, both of which are permitted under IAS 40, *Investment Property*. Under provisions of *IFRS for SMEs*, if the fair value of investment property can be measured reliably without undue cost or effort, the fair value model must be used. Otherwise, the cost method is required.
- Use of the cost-amortization-impairment model for intangible assets is required; the revaluation model set forth by IAS 38, *Intangible Assets*, is not allowed.
- Immediate expensing of borrowing costs is required; the capitalization model stipulated under revised IAS 23 is not deemed appropriate for SMEs.

- Jointly controlled entities cannot be accounted for under the proportionate consolidation method under *IFRS for SMEs*, but can be under full IFRS as they presently exist. *IFRS for SMEs* does permit the use of the fair value-through-earnings method as well as the equity method, and even the cost method can be used when it is not possible to obtain price or value data.
- Entities electing to employ *IFRS for SMEs* are required to expense development costs as they are incurred, together with all research costs. Full IFRS necessitates making a distinction between research and development costs, with the former expensed and the latter capitalized and then amortized over an appropriate period receiving economic benefits.

It should be noted that the Exposure Draft that preceded the original version of *IFRS for SMEs* would have required that the direct method for the presentation of operating cash flows be used, to the exclusion of the less desirable, but vastly more popular, indirect method. The final standard has retreated from this position and permits both methods, so it includes necessary guidance on application of the indirect method, which was absent from the draft.

All references to full IFRS found in the draft of this standard have been eliminated, except for the reference to IAS 39, which may be used, optionally, by entities reporting under *IFRS for SMEs*. The general expectation is that few reporting entities will opt to do this, since the enormous complexity of that standard was a primary impetus to the development of the streamlined *IFRS for SMEs*.

It is inevitable that some financial accounting or reporting situations will arise for which *IFRS for SMEs* itself will not provide complete guidance. The standard provides a hierarchy, of sorts, of additional literature upon which reliance could be placed, in the absence of definitive rules contained in *IFRS for SMEs*. First, the requirements and guidance that are set forth for highly similar or closely related circumstances would be consulted within *IFRS for SMEs*. Second, the *Concepts and Pervasive Principles* section (Section 2) of the standard would be consulted, in the hope that definitions, recognition criteria, and measurement concepts (e.g., for assets, revenues) would provide the preparer with sufficient guidance to reason out a valid solution. Third and last, full IFRS is identified explicitly as a source of instruction. Although reference to US (or other) GAAP is not suggested as a tactic, since full IFRS permits preparers to consider the requirements of national GAAP, if based on a framework similar to full IFRS, this omission may not indicate exclusion as such.

**Recognition and measurement simplifications.** For purposes of *IFRS for SMEs*, IASB has made significant simplifications to the recognition and measurement principles included in full IFRS. Examples of the simplifications to the recognition and measurement principles found in IFRS are as follows:

1. Financial instruments:
  - a. *Classification of financial instruments.* Only two categories for financial assets (cost or amortized cost, and fair value through profit or loss) are provided, rather than the four found in full IFRS. Because the available-for-sale and held-to-maturity classifications under IAS 39 are not available, there will be no need to deal with all of the “intent-driven” held-to-maturity rules, or related “tainting” concerns, with no need for an option to recognize changes in value of available-



for-sale securities in current profit or loss instead of as an item of other comprehensive income.

- (1) *IFRS for SMEs* requires an amortized cost model for most debt instruments, using the effective interest rate as of initial recognition. The effective rate should consider all contractual terms, such as prepayment options. Investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably are to be measured at fair value with changes in value reported in current earnings. Most other basic financial instruments are to be reported at cost less any impairment recognized. Impairment or uncollectability must always be assessed, and, if identified, recognized immediately in profit or loss; recoveries to the extent of losses previously taken are also recognized in profit or loss.
  - (2) For more complex financial instruments (such as derivatives), fair value through profit or loss is generally the applicable measurement method, with cost less impairment being prescribed for those instruments (such as equity instruments lacking an objectively determinable fair value) for which fair value cannot be ascertained.
  - (3) Assets that would generally not meet the criteria as being basic financial instruments include (a) asset-backed securities, such as collateralized mortgage obligations, repurchase agreements and securitized packages of receivables; (b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument; (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in the standard; (d) commitments to make a loan to another entity; and (e) commitments to receive a loan if the commitment can be net settled in cash. Such instruments would include (a) an investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares; (b) an interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow; (c) options and forward contracts, because returns to the holder are not fixed; (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates; and (e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change.
- b. *Derecognition*. In general, the principle to be applied is that, if the transferor retains any significant risks or rewards of ownership, derecognition is not permitted, although if full control over the asset is transferred, derecognition is valid even if some very limited risks or rewards are retained. The complex "passthrough testing" and "control retention testing" of IAS 39 can thus be omitted, unless full IAS 39 is optionally elected by the reporting entity. For financial liabilities, derecognition is permitted only when the obligation is discharged, cancelled, or expires.

- c. *Simplified hedge accounting.* Much more simplified hedge accounting and less strict requirements for periodic recognition and measurement of hedge effectiveness are specified than those set forth by IAS 39.
- d. *Embedded derivatives.* No separate accounting for embedded derivatives is required.
  - (1) *Goodwill impairment:* An indicator approach has been adopted to supersede the mandatory annual impairment calculations in IFRS 3, *Business Combinations*. Additionally, goodwill and other indefinite-lived assets are considered to have finite lives, thus reducing the difficulty of assessing impairment.
  - (2) *All research and development costs are expensed* as incurred (IAS 38 requires capitalization after commercial viability has been assessed).
  - (3) The cost method or fair value through profit or loss of accounting for associates and joint ventures may be used (rather than the equity method or proportionate consolidation).
  - (4) *Simplified accounting for deferred taxes:* The “temporary difference approach” for recognition of deferred taxes under IAS 12, *Income Taxes*, is allowed with a minor modification. Current and deferred taxes are required to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed.
  - (5) *Less use of fair value for agriculture* (being required only if fair value is readily determinable without undue cost or effort).
  - (6) *Share-based payment:* Equity-settled share-based payments should always be recognized as an expense and the expense should be measured on the basis of observable market prices, if available. When there is a choice of settlement, the entity should account for the transaction as a cash-settled transaction, except under certain circumstances.
  - (7) *Finance leases:* A simplified measurement of lessee’s rights and obligations is prescribed.
  - (8) *First-time adoption:* Less prior period data would have to be restated than under IFRS 1, *First-time Adoption of International Financial Reporting Standards*. An impracticability exemption has also been included.

Because the default measurement of financial instruments would be fair value through profit and loss under *IFRS for SMEs*, some SMEs may actually be required to apply more fair value measurements than do entities reporting under full IFRS.

### **Disclosure Requirements under *IFRS for SMEs***

There are indeed certain reductions in disclosure requirements under *IFRS for SMEs* vis-à-vis full IFRS, but these are relatively minor and alone would not drive a decision to adopt this standard. Furthermore, key stakeholders, such as banks, often prescribe supplemental disclosures (e.g., major contracts, compensation agreements) that transcend what is required under IFRS, and this would likely continue to be true under *IFRS for SMEs*.

### **Maintenance of the *IFRS for SMEs***

SMEs have expressed concerns not only over the complexity of IFRS, but also about the frequency of changes to standards. To respond to these issues, IASB intends to update *IFRS for SMEs* approximately once every three years via an “omnibus” standard, with the

expectation that any new requirements would not have mandatory application dates sooner than one year from issuance. Users are thus being assured of having a moderately stable platform of requirements.

### **SME Implementation Group**

The mission of the SME Implementation Group (SMEIG) is to support the international adoption of the *IFRS for SMEs* and monitor its implementation. The SMEIG has two main responsibilities:

- Consider implementation questions raised by users of the *IFRS for SMEs*, and develop proposed guidance in the form of questions and answers (Q&As) that would be made publicly available. The Q&As are intended to be non-mandatory guidance.
- Consider, and make recommendations to the IASB on the need to amend the *IFRS for SMEs*.

The SMEIG issued a series of Q&As up to 2012 based on the original version of the *IFRS for SMEs*. This activity ceased as the IASB began its consultation on amendments to the *IFRS for SMEs* and the Q&As issued up to that point have been incorporated into the revised *IFRS for SMEs* (and thus made mandatory) and or the IFRS Foundation's educational material (remaining non-mandatory). Further Q&As are likely to be issued as the revised *IFRS for SMEs* comes into use.

### **Implications of the *IFRS for SMEs***

*IFRS for SMEs* is a significant development that appears to be having a real impact on the future accounting and auditing standards issued by organizations participating in the standard-setting process.

On March 6, 2007, the FASB and the AICPA announced that the newly established Private Company Financial Reporting Committee (PCFRC) will address the financial reporting needs of private companies and of the users of their financial statements. The primary objective of PCFRC will be to help the FASB determine whether and where there should be specific differences in prospective and existing accounting standards for private companies.

In many Continental European countries a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of SME Standards will require breaking the traditional bond between the financial statements and the income tax return, and may well trigger a need to amend company laws.

Since it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards, differential accounting for SMEs will affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the SEC. *IFRS for SMEs* may be a welcome relief for auditors as it will decrease the inherent risk that results from the numerous choices and judgement required by management when utilizing the full version of IFRS. The ultimate success of *IFRS for SMEs* will depend on the extent to which users, preparers and their auditors believe the standards meet their needs.

when it develops new standards, and by others to help them understand and apply the IASB's standards. The Exposure Draft's proposals are examined in more detail later in this chapter.

## **CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010**

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### **Purpose and Status**

The purpose of the conceptual framework is to set out the concepts that underlie the preparation and presentation of financial statements. The preparation of financial statements is based on estimates, judgements and models rather than exact depictions. The conceptual framework provides the concepts on which these uncertainties are based.

The main aim is therefore to help the IASB in preparing new standards and reviewing existing standards. The conceptual framework also helps national standard setters, preparers, auditors, users and others interested in IFRS in completing their tasks. The conceptual framework is, however, not regarded as an IFRS and can therefore not override any IFRS although there might be potential conflicts. The IASB believes that over time any such conflicts will be removed.

### **The Accounting Model**

The introduction to the conceptual framework states that accounting statements are most commonly prepared in accordance with an accounting model based on recoverable historical cost and the nominal financial capital maintenance concept. Other models and concepts may be more appropriate but there is currently no consensus for change. The conceptual framework is prepared to be applicable to a wide range of accounting models and concepts of capital and capital maintenance. It is envisaged that the objective and qualitative characteristics in the conceptual framework will be used to make the appropriate decisions.

### **The Objective of General-Purpose Financial Statements**

The objective of general-purpose financial statements in the conceptual framework is defined as follows:

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

The objective confirms the decision-useful orientation on which financial reporting is based. It is clearly stated that financial reporting does not provide information regarding the value of a reporting entity, but assists in making such valuations. The information needs of investors, lenders, and other creditors are the main focus. They are the primary users since they cannot require direct information from the reporting entity. They make decisions regarding the purchase or sale of equity and debt instruments or to provide finance to the entity.

The conceptual framework holds that users need to evaluate the prospects for future net cash inflows to an entity. To assess these net inflows information is needed of an entity's resources, claims to those resources, and the ability of management and governing board to discharge their responsibility to use the resources. Assessing stewardship is thus included in the ability of users to assess the net cash flows of an entity.

General-purpose financial statements provide information about the financial position of an entity, its resources, and claims against the resources. The financial position is affected by the

economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information is provided about the strengths and weaknesses of an entity and its ability to acquire finance.

Changes in an entity's resources and claims are a result of an entity's financial performance and are derived from other transactions such as issuing debt and equity instruments. Financial performance is assessed both through the process of accrual accounting and changes in cash flows. This helps users to understand the return on the resources of an entity and how well management has discharged its stewardship responsibilities. Both these changes and the implications of these changes reflected in the historical information help to assess future performance.

### Qualitative Characteristics of Useful Financial Information

The qualitative characteristics identify the information that is most useful in financial reporting. Financial reporting includes information in financial statements and financial information that is provided by other means. The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics. The fundamental qualitative characteristics are relevance and faithful representation. The enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability.

No hierarchy of applying the qualitative characteristics is determined. The application is, however, a process. The fundamental characteristics are applied by following a three-step process. Firstly, identify the economic phenomenon that has a potential to be useful. Secondly, identify the type of information regarding the phenomenon that is most relevant that could be faithfully represented. Finally, determine whether the information is available and could be faithfully represented. After that the enhancing characteristics are applied to confirm or enhance the quality of the information. The different qualitative characteristics are explained as follows:

**Relevant** financial information is capable of making a difference in decision making.

Information is capable of making a difference if it has predictive value, confirmatory value or both. Financial information has predictive value if it can be used as input in the process to predict future outcomes, and has confirmatory value if it provides feedback about previous evaluations. Materiality is included in relevance. Information is material if omitting it or misstating it could influence the decisions of users.

**Faithful representation** faithfully represents the phenomena it purports to represent. It includes three characteristics: complete, neutral, and free from error. A complete depiction includes all information needed to understand the phenomena. A neutral depiction is without bias. Free from error means that there are no errors or omissions in the description of the phenomena and in the process applied.

**Comparability** refers to the ability to identify similarities in, and differences among, items. *Consistency* (the use of the same accounting policies and procedures within an entity from period to period, or in a single period across entities) aids comparability.

**Verifiability** helps to assure users that information represents faithfully the economic phenomena that it purports to represent. It implies that knowledgeable and independent observers could reach a general consensus (but not necessarily absolute agreement) that the information does represent faithfully the economic phenomena it purports to represent without material error or bias, or that an appropriate recognition or measurement method has been applied without material error or bias. It means that independent observations would yield essentially the same measure or conclusions.

**Timeliness** means that the information is provided in time to be capable of influencing decisions. Generally, the older the information is the less useful it may be to the users.

**Understandability** is classifying, characterizing and presenting information clearly and concisely. Understandability enables users who have a reasonable knowledge of business and economic and financial activities and financial reporting, and who apply reasonable diligence to comprehend the information, to gain insights into the reporting entity's financial position and results of operations, as intended.

The cost constraint is the only constraint included regarding the information provided in useful financial reports. The question is whether the benefits of providing information exceed the cost of providing and using the information. Presumably this will constrain the imposition of certain new requirements, although this is a relative concept, and as information technology continues to evolve and the cost of preparing and distributing financial and other information declines, this constraint conceivably will be relaxed as well.

### **The 1989 Framework: The Remaining Text**

The current guidance of the IASB's 1989 framework, not changed by the new objective and qualitative characteristics, is included in Chapter 4 of the 2010 conceptual framework. More detailed discussions of the remaining text are included in other chapters of this book. For instance, the definitions of assets, liabilities, and equity are discussed in greater detail in Chapter 4, *Statement of Financial Position*. Only a brief discussion follows below.

The going concern assumption is retained. Financial statements are prepared on the assumption that the entity is a going concern and will continue its operation in the future.

Elements determining the financial position are still assets, liabilities and equity. The current definitions in the 1989 framework are retained: An asset is "a resource controlled by the entity as a result of past events and 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 future benefits." Equity is simply a residual arrived at by deducting the liabilities from assets.

The elements determining financial position are income and expenses. Elements are identified based on the substance and economic reality of the transaction or events and not based on the legal form. Elements are only recognized in the financial statements when they are probable and have a cost or value that can be measured reliably, which means that some assets and liabilities may go unrecognized.

Measurement is the assignment of a monetary amount to an element. The following measurement bases are identified, without determining when they should be applied: Historical cost, current cost, realizable value and present value. Currently, in IFRS other measurement bases, such as amortized cost and fair value, are applied that are not mentioned in the conceptual framework.

Finally financial capital maintenance and physical capital maintenance are still identified as the concepts of capital maintenance.

## **CONCEPTUAL FRAMEWORK PROJECT**

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### **2013 Discussion Paper**

The IASB issued a Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* in July 2013 to obtain feedback on the main areas that the IASB

will consider in developing a new framework. The areas dealt with in the Discussion Paper include:

- The scope of the conceptual framework;
- The definitions of assets and liabilities;
- The recognition and derecognition of assets and liabilities;
- Equity and its separation from liabilities;
- Measurement;
- Profit or loss and other comprehensive income (OCI); and
- Presentation and disclosure.

The IASB decided not to include the reporting entity in the discussion as they received feedback on this topic on the Exposure Draft for Phase D, *Reporting Entity*. The Reporting Entity Exposure Draft describes a reporting entity as follows:

*A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.*

The Reporting Entity Exposure Draft clarifies that the existence of a legal entity is neither necessary nor sufficient to identify a reporting entity. Further, a reporting entity can include more than one entity or it can be a portion of a single entity.

This Exposure Draft confirms that if an entity controls one or more entities, it should present consolidated financial statements. An entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself. However, if one entity has *significant influence* over another entity, it specifically does not control that other entity. “Parent-only” financial statements may be presented provided they are presented with consolidated financial statements. Combined financial statements may be prepared for commonly controlled entities in a group.

In May 2014 the IASB published a Staff Paper setting out the tentative decisions it has made as a result of responses received to the July 2013 Discussion Paper. The Staff Paper notes that all tentative decisions made would be exposed for public comment in an Exposure draft of a revised conceptual framework.

The IASB has tentatively decided that assets should be viewed as rights, or bundles of rights, rather than underlying physical or other objects. The draft definition of an asset has been amended to state that it is a present economic resource controlled by the entity as a result of past events, whilst a liability is defined as a present obligation of the entity to transfer an economic resource as a result of past events. Economic resources are rights that are capable of producing economic benefits.

The IASB also tentatively decided to amend Chapter 1 of the conceptual framework to increase the prominence of stewardship within the overall objective of financial reporting, and to reintroduce a reference to prudence in the conceptual framework.

### **Exposure Draft—Conceptual Framework for Financial Reporting**

Following on from the 2013 Discussion Paper, on 28 May 2015 the IASB published for public comment an Exposure Draft proposing a revised conceptual framework. The comment period on the Exposure Draft closed on 26 October 2015. The IASB’s stated

aim is to improve the quality of financial reporting by providing a more complete, clearer and updated set of concepts that can be used by the IASB when it develops IFRSs, and by others to help them understand and apply those standards. The framework proposed in the Exposure Draft:

- Is more complete than the 2010 conceptual framework because it addresses a number of areas which are either not covered, or not covered in sufficient detail, in the earlier framework. These areas include measurement, financial performance (including the use of other comprehensive income), presentation & disclosure, derecognition and the reporting entity; and
- Clarifies some aspects of the 2010 framework. These clarifications include the assertion that the information needed to meet the objective of financial reporting includes information that can be used to help assess management's stewardship of the entity's resources, explanations of the roles of prudence and substance over form in financial reporting, the assertion that a high level of measurement uncertainty can make financial information less relevant, the assertion that important decisions on, for example, recognition and measurement are driven by considering the nature of the resulting information about both financial performance and financial position, and the provision of clearer definitions of assets and liabilities and more extensive guidance to support those definitions; and
- Updates the parts of the 2010 framework which are out of date. For example, proposed framework clarifies the role of probability in the definitions of assets and liabilities.

The Exposure Draft adopts the sections of the 2010 framework covering the Objective of General Purpose Financial Reporting, the Qualitative Characteristics of Useful Financial Information and Concepts of Capital and Capital Maintenance with only limited changes. New sections are included dealing with Financial Statements and the Reporting Entity, the Elements of Financial Statements, Recognition and Derecognition, Measurement, and Presentation and Disclosure.

### ***Chapter 1—The Objective of General Purpose Financial Reporting***

The IASB has decided not to fundamentally reconsider this area, although some relatively minor changes to the wording of the equivalent chapter in the 2010 framework are proposed. These serve to give more prominence to the importance of providing information needed to assess management's stewardship of the entity's resources.

### ***Chapter 2—Qualitative Characteristics of Useful Financial Information***

The IASB has decided not to fundamentally reconsider this area, although some relatively minor changes to the wording of the equivalent chapter in the 2010 framework are proposed.

An explicit reference to the notion of prudence is reintroduced. The proposed framework describes prudence as the exercise of caution when making judgements under conditions of uncertainty. It is noted that the exercise of prudence means that assets and income are not overstated and that liabilities and expenses are not understated, and that this also avoids the understatement of assets and income and the overstatement of liabilities and expenses because this could lead to the overstatement of income or the understatement of expenses in future periods.



In connection with the characteristic of faithful representation the proposed framework notes that a faithful representation provides information about the substance of an economic phenomenon rather than merely about its legal form. It is noted that providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation.

The IASB notes that a number of respondents to the Discussion Paper were concerned at the removal of reliability as a qualitative characteristic of useful financial information from the 2010 framework. The IASB proposes addressing this by clarifying that measurement uncertainty is one factor which can make financial information less relevant. Thus there is a trade-off between the level of measurement uncertainty and other factors that make information relevant.

### ***Chapter 3—Financial Statements and the Reporting Entity***

The newly-written Chapter 3 discusses the role of financial statements and the concept of the reporting entity.

In describing the role of financial statements the proposed framework states that financial statements are prepared from the perspective of the entity as a whole, instead of from the viewpoint of any particular group of investors, lenders or other creditors. It also sets out the going concern assumption, which has been brought forward from the 2010 framework with little change.

The proposed framework describes a reporting entity as an entity which chooses, or is required, to prepare general purpose financial statements. It notes that a reporting entity is not necessarily a legal entity, and could comprise a portion of an entity, or two or more entities.

The proposed framework discusses the boundary of a reporting entity and notes that, in situations where one entity has control of another entity, the boundary of the reporting entity can be determined either by direct control only (resulting in unconsolidated financial statements) or by direct and indirect control (resulting in consolidated financial statements). Where a reporting entity is not a legal entity, the boundary of the reporting entity needs to be set in such a way that the financial statements provide the relevant financial information needed by those existing and potential investors, lenders and other creditors who rely on the financial statements, and faithfully represent the economic activities of the entity.

The IASB expresses the view that consolidated financial statements are usually more likely than unconsolidated financial statements to provide useful information to users, but that unconsolidated financial statements may also provide useful information. It states that in situations where an entity produces unconsolidated financial statements, whether because it chooses to or is required to, it should disclose how users may obtain the consolidated financial statements.

### ***Chapter 4—The Elements of Financial Statements***

Chapter 4 deals with the elements of financial statements, including assets, liabilities, equity, income and expenses. The proposed framework notes that financial statements provide information about the financial effects of transactions and other events by grouping them into broad classes – the elements of financial statements.

An **asset** is defined as a present economic resource controlled by the entity as a result of past events. An economic resource is defined as a right that has the potential to produce economic benefits.

A **liability** is defined as a present obligation of the entity to transfer an economic resource as a result of past events.

**Equity** is defined as the residual interest in the assets of the entity after deducting all of its liabilities.

**Income** is defined as increases in assets or decreases in liabilities which result in increases in equity, other than those relating to contributions from holders of equity claims.

**Expenses** are defined as decreases in assets or increases in liabilities which result in decreases in equity, other than those relating to distributions to holders of equity claims.

The proposed framework also recognizes other changes in resources and claims, being either contributions from, and distributions to, holders of equity claims, and exchanges which do not result in increases or decreases in equity (for example, acquiring an assets for cash).

As will be seen from the above, the proposed framework continues to define income and expenses in terms of changes in assets and liabilities but also notes that important decisions on matters such as recognition and measurement are driven by considering the nature of the resulting information about both financial performance and financial position.

The IASB notes that it is not proposing in the Exposure Draft to change the definitions of equity and liabilities to address the problems that arise in classifying instruments with characteristics of both equity and liabilities. It states that it is considering these matters in its project on financial instruments with the characteristics of equity. The outcomes of that project will assist the IASB in deciding whether it should add a project on amending standards, the conceptual framework or both to its active agenda.

Chapter 4 also includes proposed guidance on the term “present obligation” which is included within the definition of a liability. The proposed guidance states that an entity has a present obligation to transfer an economic resource if the entity has no practical ability to avoid the transfer AND the obligation has arisen from past events (in other words the entity has received the economic benefits or conducted the activities which establish the extent of its obligation).

Chapter 4 also includes proposals for further guidance on the definitions of the elements, on executory contracts, on reporting the substance of contractual rights and contractual obligations, and on the unit of account.

### ***Chapter 5—Recognition and Derecognition***

Chapter 5 discusses recognition and derecognition.

The basis on which assets and liabilities (and any related income, expenses or changes in equity) are to be recognized is stated to be if such recognition provides users of financial statements with relevant information about the asset or liability and about any income, expenses or changes in equity, a faithful representation of the assets or liability and of any income, expenses or changes in equity, and information that results in the benefits exceeding the cost of providing that information.

Certain circumstances are identified in which the above criteria may not be met, including if it is uncertain whether an asset exists or is separable from goodwill, or whether a liability exists, if there is only a low probability that an inflow or outflow of economic benefits will result, and if a measurement of an asset or liability is available but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available.

It is proposed that the accounting requirements for derecognition should aim to represent faithfully both any assets and liabilities retained after the transaction or other event that led to the derecognition, and the change in the entity's assets and liabilities as a result of that transaction or other event.

The Exposure Draft notes that most decisions about derecognition are straightforward, with the discussion in the proposed framework focusing on cases where the two aims referred to above conflict with each other. For example, where the retained component contains a disproportionate exposure to variations in economic benefits, derecognition may faithfully represent the fact that the entity no longer has the components that have been transferred, but may not faithfully represent the extent of the change in the entity's assets or liabilities as a result of the transaction. Alternatively, it may be the case that at the same time as transferring an asset, the entity enters into another transaction (for example, a forward contract, a written put option, or a purchased call option) under which the entity must or may reacquire the asset. Because the component that has been transferred must or may be reacquired, derecognizing it may misrepresent the extent of the change in the entity's financial position. It is noted that in some of these circumstances, derecognition may achieve the two aims described above if supported by separate presentation, or explanatory disclosure, in the notes to the financial statements. However, where this is not sufficient to achieve the two aims it may be necessary to continue to recognize not only the retained component but also the transferred component without recognizing any income or expenses on the transaction and with any proceeds received or paid being treated as a liability or asset respectively, and separate presentation or explanatory disclosure being given to confirm that the entity no longer has any rights or obligations under the transferred component.

Proposed guidance on derecognition is also given for situations where contracts are modified.

## ***Chapter 6—Measurement***

Chapter 6 discusses different measurement bases, the information that they provide and their advantages and disadvantages, and factors to consider when selecting a measurement basis.

Measurement bases are categorized as either historic cost or current values. Four measurement bases are then described, being historic cost, current value, fair value, and value in use (for assets) or fulfillment value (for liabilities), alongside a discussion of the information which each basis provides.

Guidance is provided on factors to consider when selecting a measurement basis. It is noted that for the information provided by a particular measurement basis to be useful to the users of the financial statements, it must be relevant and it must faithfully represent what it purports to represent. Cost is recognized as a constraint on the selection of a measurement basis, as it is with all other areas of financial reporting. The enhancing qualitative characteristics of comparability, verifiability and understandability are also recognized as having implications for the selection of a measurement basis, but it is noted that timeliness does not have such implications.

Situations where more than one measurement basis is needed to provide information about an asset, liability, income or expense are discussed and it is noted that, in most cases, the most understandable way to provide such information is to use one measurement basis in both the statement of financial position and the statement(s) of financial performance, and to use the other measurement basis for disclosure only. However, in some cases more relevant

information may be provided by using a current value measurement basis in the statement of financial position and a different measurement basis to determine the related income or expenses in the statement of profit and loss.

### ***Chapter 7—Presentation and Disclosure***

Chapter 7 discusses the objective and scope of financial statements, presentation and disclosure as communication tools, and information about financial performance.

In the commentary on the objective and scope of financial statements it is noted that financial statements provide information about an entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources. Some of this information is provided by the recognition of items that meet the definition of an element in the statements of financial position and financial performance. Financial statements also provide additional information about recognized items and items that meet the definition of an element but that have not been recognized.

Forward-looking information about likely or possible future transactions and events is included in financial statements only if that information is relevant to understanding the entity's assets, liabilities and equity that existed at the end of, or during, the period (even if they are unrecognized), or income and expenses for the period.

As regards presentation and disclosure as communication tools, the proposed framework states that efficient and effective communication of the information presented or disclosed in the financial statements improves its relevance and contributes to a faithful representation of the assets, liabilities, equity, income and expenses. Efficient and effective communication includes classifying information in a structured manner which reports similar items together and dissimilar items separately, aggregating information so that it is not obscured by unnecessary detail, and using presentation and disclosure objectives and principles instead of rules which could lead to purely mechanistic compliance.

In relation to information about financial performance, the proposed framework does not prescribe a single-statement or dual-statement structure for the statement of financial performance. It refers to the statement (or section) of profit and loss as the primary source of information about an entity's financial performance for the period, and requires a total (or subtotal) for profit or loss to be provided. Profit or loss is not defined, but it is stated that the income and expenses included in the statement of profit or loss are the primary source of information about the entity's financial performance for the period. From this there follows a rebuttable presumption that all income and expenses will be included in the statement of profit or loss. Income or expenses may only be reported outside the statement of profit or loss and included in other comprehensive income if the income or expenses relate to assets or liabilities measured at current values, and excluding those values from the statement of profit or loss would enhance the relevance of the information in the statement of profit or loss for the period.

It is further presumed that items of income or expenses included in other comprehensive income in one period will be reclassified into the statement of profit or loss in some future period (i.e., be recycled), if doing so will enhance the relevance of the information included in the statement of profit or loss for that future period. This presumption could be rebutted, for example, if there is no clear basis for identifying the period in which that reclassification would enhance the relevance of the information in the statement of profit or loss. If there is no such basis, it may indicate that the income or expense should not be included in other comprehensive income.

### **Chapter 8—Concepts of Capital and Capital Maintenance**

The IASB has decided not to fundamentally reconsider this area, although some minor changes to the wording of the equivalent chapter in the 2010 framework are proposed. These changes are made solely to achieve consistency of terminology throughout the proposed framework. For instance, references to “owners” are replaced with “holders of equity claims.”

## **HIERARCHY OF STANDARDS**

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The conceptual framework is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts will articulate their arguments in terms of the conceptual framework. However, the conceptual framework is not normally intended to be used directly by preparers and auditors in determining their accounting methods. In the 2003 revision of IAS 8 the IASB introduced a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1. IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.
2. In the absence of such a directly applicable standard, judgement is to be used to develop and apply an accounting policy that conforms to the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expense set forth in the *Framework*.
3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop their standards, as well as other accounting literature and industry practices that do not conflict with guidance in IFRS dealing with the same or similar circumstances or with definitions set forth in the *Framework*.

## **IFRS PRACTICE STATEMENT MANAGEMENT COMMENTARY**

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### **Nature and Scope**

IFRS Practice Statement *Management Commentary* was issued in December 2010 and is prospectively applicable. The Practice Statement provides a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRS. It is therefore not an IFRS standard, and local authorities may voluntarily choose to implement the Practice Statement. However, it is foreseen that many countries will not implement the Practice Statement and will implement the developments regarding integrated reporting instead. Further, many local authorities have similar local guidance.

Management commentary is a narrative report that provides the content within the financial position, financial performance, and cash flows of an entity that needs to be interpreted. Management also has the opportunity to explain its objectives and strategies applied to fulfill those objectives. Management commentary falls in the scope of financial reporting and thus the conceptual framework, and should be read in conjunction with the conceptual framework. The Practice Statement provides the principles, elements, and qualitative characteristics of decision-useful information regarding management commentary, and therefore assists management in presenting management commentary.

Management needs to identify the extent of applying the Practice Statement. Full compliance can only be claimed if an entity complies with all the requirements. In applying the Practice Statement, management must consider the needs of the primary users of financial statements. The primary users are similar to the 2010 conceptual framework: existing and potential investors, lenders and other creditors.

### **Principles**

Management commentary is based on the principles of providing management's view and supplementing and complementing information presented in the financial statements. Management commentary should include forward-looking information and information possessing the qualitative characteristics described in the conceptual framework. The principles of management view present management perspective and should be derived from the information important to management decision making.

Supplementary and complementary information explains the amounts provided in financial statements and the conditions and events forming that information. It includes all information that is important in understanding the financial statements.

Regarding forward-looking information, it must provide management perspective regarding the entity's direction. It does not predict the future, but focuses more on the entity's objectives and strategies to achieve those objectives. Forward-looking information is provided regarding uncertainties, trends and factors that could influence an entity's revenue, performance, liquidity and capital resources. Forward-looking information is provided through both narrative descriptions and quantitative data and must include disclosures of the assumptions used.

### **Qualitative Characteristics**

The conceptual framework fundamental qualitative characteristics of relevance and faithful representation are applied and the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability should be maximized. Management should include all information that is material to its management commentary.

### **Presentation**

The presentation of management commentary should be clear and straightforward. Management commentary should be consistent with the related financial statements, avoid duplication, and avoid generic disclosure. To assist in assessing the performance of an entity, management commentary should include the entity's risk exposures, the risk strategies and how effective the strategies are, how resources recognized could affect the financial performance, and how non-financial information affects the financial statements.

### **Elements**

The following main elements should be included:

- Nature of business;
- Management's objectives and strategies to achieve the objectives;
- The most significant sources, risks and relationships;
- The results of the entity's operations and prospects; and
- The critical performance measures and indicators used by management to assess the performance against objectives.

A description of the business to understand the entity and its environment is the starting point of management commentary. It includes information about the entity's industry, its market and competition, the legal, regulative and macroeconomic environment, its main projects, services, business processes and distribution channels, structure and how it creates value.

Objectives and strategies, and changes thereof, must be disclosed in a way that users can understand the priorities and the resources used to achieve them. This includes performance indicators and the time frame over which success is measured. Relationships between objectives, strategies, management actions and executive remunerations are also helpful.

A clear description of the most important resources, risks and relationships that affect entity's value and how they are managed is needed. This includes analysis of financial and non-financial resources, capital structure, financial needs, liquidity and cash flows, and human and intellectual capital. Risk disclosure includes principle risk exposures, changes therein, uncertainties, means of mitigating risks and effectiveness of risk strategies. Risk disclosure could be divided in principle strategic, commercial, operational and financial risks. Significant relationships with stakeholders that are value driven and managed should also be disclosed.

A clear description of financial and non-financial performances and prospects should be included. A description of performance and progress during the year helps to predict the future by identifying main trends and factors affecting the business. Comparison of financial position, performance, liquidity and financial position with previous years is essential.

Performance measures and indicators (financial and non-financial) used by management should be disclosed and the reasons why they change over time. This increases comparability of management commentary over time.

## US GAAP COMPARISON

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The FASB Framework consists of different concept statements. Chapters one and two of the new joint framework have also been included in the FASB Framework as CON 8. Both frameworks focus on the asset and liability approach and define assets and liabilities similarly. The IASB *Framework* only defines two elements of changes in assets and liabilities, namely income and expenses. The FASB Framework identifies more elements such as investments by owners, distributions to owners and other comprehensive income, and subdivides comprehensive income into revenue, expenses, gains and losses. The FASB Framework does not identify probability as a recognition criterion, but includes relevance as a recognition criterion. The FASB Framework separates measurement in (1) a selection of the monetary unit and (2) choice of attribute. Both frameworks provide a list of measurement attributes but provide no guideline on when each should be applied. Both frameworks also do not have an adequate concept of the reporting entity.

The FASB does have an active project on the definition of a non-public entity. The goal of the project is to re-examine the definition of a non-public entity and a public entity in the FASB Accounting Standards Codification®. The FASB issued Accounting Standards Update 2013-12 in December 2013 that defines a public entity to fulfill phase one of this project. When complete, entities that are not defined as public entities will be in scope of the Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies. Phase 2 is underway.

While the FASB's conceptual framework project continues, it is no longer a joint project with the IASB. The IASB has pursued advancement of the conceptual framework through

the Accounting Standards Advisory Forum meetings. The FASB participates in those meetings as a representative of the USA.

The FASB has held several meetings on a project entitled *Disclosure Framework—Board's Decision Process*. The objective and primary focus of the Disclosure Framework project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements. It is anticipated that the result will be a lower volume of disclosures, although that is not a primary goal.

Regarding the IFRS Practice Statement for Management commentary, the US Securities and Exchange Commission maintains regulations that specify the form and content of management commentary as well as other disclosures.

In August 2014, the FASB issued Accounting Standards Update 2014–15—*Presentation of Financial Statement—Going Concern*. The main provisions of this Update are that in connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Additionally, the Update requires management to consider plans that are in place to mitigate the risks of an entity's ability to continue as a going concern. If management concludes it is not able to continue as a going concern, it must make specific disclosures. Prior to this update, US GAAP provided no guidance to management about assessing and disclosing doubts about the ability of the entity to continue as a going concern; however, US auditing and public company regulations did provide such guidance. The Update is effective for annual and interim financial statements issued after December 15, 2016.



## **US GAAP COMPARISON**

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US GAAP has no single pronouncement that defines presentation of financial statements. The format and content for public companies are prescribed by presentation requirements in the respective standards and by Securities Exchange Commission rules.

FASB's project on Financial Statement Presentation is inactive.

current IASB—developed conceptual frameworks intended to serve as the fundamental theory of financial reporting. Undertaking that exercise had the result of causing accounting theory to revert to the original purpose—namely, to measure economic activity—and to implicitly adopt the definition of income as the change in wealth from period to period. With this in mind, measurement of that wealth, as captured in the balance sheet, became more central to new standards development efforts.

In practice, IFRS as currently written are a mixture of both approaches, depending on the transaction being recognized, measured and reported. This mixed attribute approach is partially a legacy of earlier financial reporting rule making, but also reflects the practical difficulties of value measurement for many categories of assets and liabilities. For example, many financial instruments are remeasured at the end of each reporting period, whereas property, plant and equipment are normally held at original cost and are depreciated systematically over estimated useful lives, subject to further adjustment for impairment, as necessary.

However, while existing requirements are not entirely consistent regarding financial statement primacy, both the IASB and the FASB, when developing new accounting standards, are now formally committed to a statement of financial position (balance sheet)-oriented approach. The conceptual framework is expressed in terms of measuring assets and liabilities, and reportedly the two standard-setting bodies and their respective staff analyse transactions affected by proposed standards from the perspective of whether they increase or diminish the assets and liabilities of the entity. Overall, the IASB sees financial reporting as being based on the measuring of assets and liabilities, and has the overall goal of requiring the reporting of all changes to them (other than those which are a result of transactions with owners, such as the payment of dividends) in a statement of comprehensive income.

The focus on earnings in the capital markets does not mean that the statement of financial position is irrelevant; clearly the financial structure of the company is an important aspect of the company's risk profile, which in turn is important to evaluating the potential return on an investment from the perspective of a current or potential shareholder. Lenders have an even greater interest in the entity's financial structure. This is why companies sometimes go to great lengths to keep some transactions off the statement of financial position, for example by using special-purpose entities and other complex financing structures. IAS 32 considers that any instrument that gives rise to a right to claim assets from an entity is a liability.

IAS 1 states that “each material class of similar items” should be presented separately in the financial statements. In addition, “items of dissimilar nature or function” should be presented separately, unless they are immaterial. The standard expresses a preference for a presentation based on the current/non-current distinction, but allows a presentation by liquidity if that is more reliable and relevant. An asset or liability is current if it is part of the reporting entity's normal operating cycle (e.g., customer receivables) or if it will be realized or settled within twelve months after the reporting period. Only one of these conditions needs to be satisfied—so, for example, inventory that remains on hand for two years should still be classified as current, while long-term liabilities should be reclassified as current for the final year before settlement. IAS 1 includes a sample of illustrative financial statement structure in its *Guidance on Implementing IAS 1*, but use of this format is optional.

#### Sources of IFRS

IAS 1, 8, 10, 24, 32, 36, 38, 39, 40, 41

IFRS 5, 6

## SCOPE

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This chapter discusses the format and content of the statement of financial position by incorporating guidance from the conceptual framework, IAS 1 and other standards.

## DEFINITIONS OF TERMS

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The IASB conceptual framework describes the basic concepts by which financial statements are prepared. It does so by defining the objective of financial statements; identifying the qualitative characteristics that make information in financial statements useful; and defining the basic elements of financial statements and the concepts for recognizing and measuring them in financial statements.

The elements of financial statements are the broad classifications and groupings which convey the substantive financial effects of transactions and events on the reporting entity. To be included in the financial statements, an event or transaction must meet definitional, recognition and measurement requirements, all of which are set forth in the conceptual framework.

The elements of a statement of financial position are:

**An asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The following three characteristics must be present for an item to qualify as an asset:

1. The asset must provide probable future economic benefit that enables it to provide future net cash inflows.
2. The entity is able to receive the benefit and restrict other entities' access to that benefit.
3. The event that provides the entity with the right to the benefit has occurred.

In addition, the asset must be capable of being measured reliably. The conceptual framework states that reliable measurement means that the number must be free from material error and bias and can be depended upon by users to represent faithfully. In the Basis for Conclusions of IFRS 2, the IASB notes that the use of estimates is permitted, and that there may be a trade-off between the characteristics of being free from material error and having representational faithfulness.

Assets have features that help identify them in that they are exchangeable, legally enforceable, and have future economic benefit (service potential). It is that potential that eventually brings in cash to the entity and that underlies the concept of an asset.

**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 future benefits.

The following three characteristics must be present for an item to qualify as a liability:

1. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand when a specified event occurs or at a particular date.
2. The obligation cannot be avoided.
3. The event that obligates the entity has occurred.

Liabilities are similarly recognized subject to the constraint that they can be measured reliably.

Liabilities usually result from transactions that enable entities to obtain resources. Other liabilities may arise from non-reciprocal transfers, such as the declaration of dividends to the owners of the entity or the pledge of assets to charitable organizations.

An entity may involuntarily incur a liability. A liability may be imposed on the entity by government or by the court system in the form of taxes, fines, or levies. A liability may arise from price changes or interest rate changes. Liabilities may be legally enforceable or they may be equitable obligations that arise from social, ethical or moral requirements. Liabilities continue in existence until the entity is no longer responsible for discharging them.

The diagram that follows, which is taken from one of the statements produced from the conceptual framework project by the US standard setter, the FASB, identifies the three classes of events that affect an entity, and shows the relationship between assets and liabilities, on the one hand, and comprehensive income, on the other.

**Equity** is the residual interest in the assets that remains after deducting all of its liabilities.

In a business enterprise, the equity is the ownership interest. Equity arises from the ownership relation and is the basis for distributions of earnings to the owners. Distributions of entity assets to owners are voluntary. Equity is increased by owners' investments and comprehensive income and is reduced by distributions to owners.

In practice, the distinction between equity and liabilities may be difficult to determine. Securities such as convertible debt and certain types of preference shares may have characteristics of both equity (residual ownership interest) and liabilities (non-discretionary future sacrifices). Equity, aside from exchanges with owners, is a residual of the asset/liability recognition model.

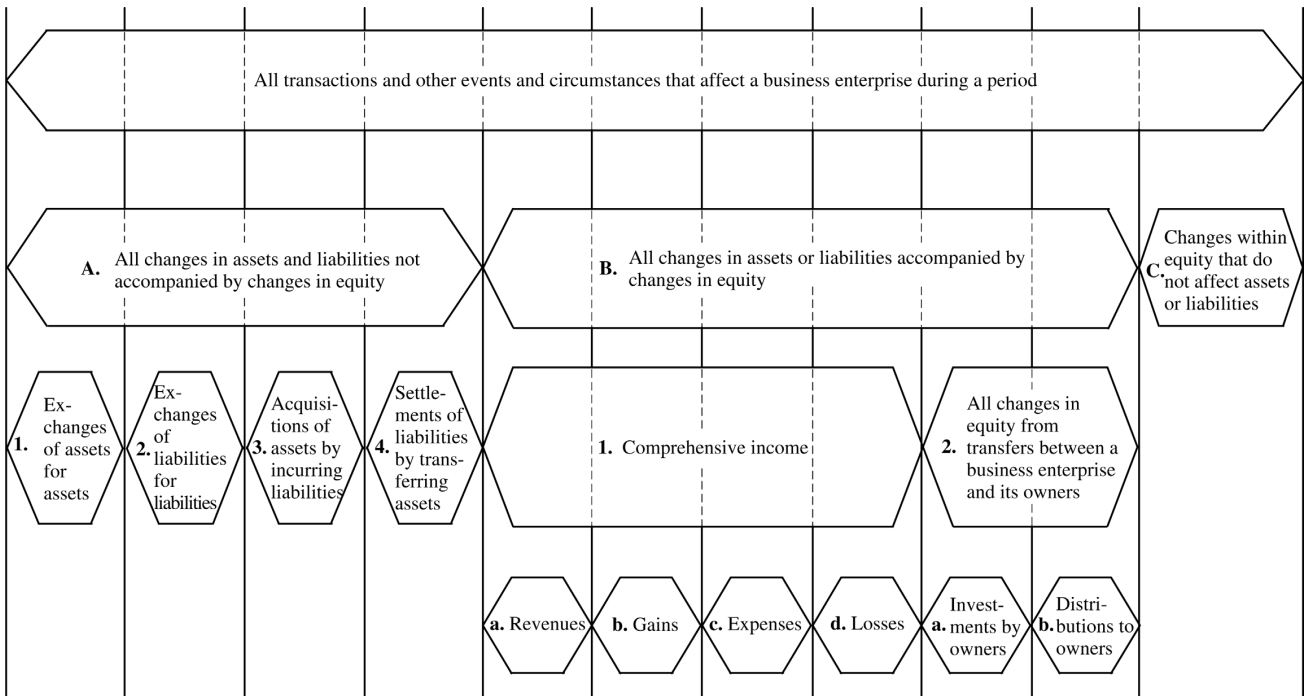
**Statement of financial position** is a statement of financial position (balance sheet) presents an entity's assets, liabilities, and equity as of a specific date.

## GENERAL CONCEPTS, STRUCTURE AND CONTENT

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### General Concepts

Under IFRS, assets and liabilities are recorded at cost or fair value at inception in the financial statements, which for assets and liabilities arising from arm's-length transactions will generally be equal to negotiated prices. Subsequent measurement is under the historical cost principle or fair value, depending on the requirements of the standard and accounting policy election made by the entity. IAS 36, *Impairment of Assets*, requires assets to be reduced in value if their carrying value exceeds the higher of fair value or value in use (expected future cash flows from the asset). IAS 39, *Financial Instruments: Recognition and Measurement*, IAS 40, *Investment Property* and IAS 41, *Agriculture*, all include some element of subsequent measurement at fair value. Where assets are classified as held-for-sale, they are carried at the lower of their carrying amount or fair value less selling costs (IFRS 5).



Historical exchange prices, and the amortized cost amounts that are later presented, are sometimes cited as being useful because these amounts are objectively determined and capable of being verified independently. However, critics point out that, other than at transaction date, historical cost does not result in presenting in the statement of financial position numbers that are comparable between companies, so while they are reliable, they may not be relevant for decision-making purposes. This captures the fundamental conflict regarding accounting information: absolutely reliable or objective information may not be very relevant to current decision making.

### **Structure and Content**

The titles commonly given to the primary financial statement that presents an entity's financial position include the statement of financial position or balance sheet. The revised IAS 1 changed the title of the "balance sheet" to the "statement of financial position," the title used throughout this publication. The IASB concluded that "statement of financial position" better reflects the function of the statement and is consistent with the conceptual framework. In addition, the title "balance sheet" simply reflected the convention that double entry bookkeeping requires all debits to equal credits, and did not identify the content or purpose of the statement. According to the IASB, the term "financial position" was a well-known and accepted term, and had already been used in auditors' opinions internationally for more than 20 years to describe what "the balance sheet" presents.

The three elements that are always to be displayed in the heading of a statement of financial position are:

1. The entity whose financial position is being presented;
2. The title of the statement; and
3. The date of the statement.

The entity's name should appear exactly as written in the legal document that created it (e.g., the certificate of incorporation, partnership agreement, etc.). The title should also clearly reflect the legal status of the entity as a corporation, partnership, sole proprietorship, or division of some other entity.

The statement of financial position presents a "snapshot" of the resources (assets) and claims to resources (liabilities and equity) as at a specific date. The last day of a month is normally used as the statement date (in jurisdictions where a choice is allowed) unless the entity uses a fiscal reporting period always ending on a particular day of the week, such as a Friday or Sunday (e.g., the last Friday in December, or the Sunday falling closest to December 31). In these cases, the statement of financial position can appropriately be dated accordingly (i.e., December 26, October 1, etc.). In all cases, the implication is that the statement of financial position captures the pertinent amounts as of the close of business on the date noted.

Statements of financial position should generally be uniform in appearance from one period to the next, as indeed should all of the entity's financial statements. The form, terminology, captions, and pattern of combining insignificant items should be consistent. The goal is to enhance usefulness by maintaining a consistent manner of presentation unless there are good reasons to change these and the changes are duly reported.

IAS 1 does not prescribe the sequence or format in which items should be presented in the statement of financial position. Thus, for example, in a standard classified statement of financial position non-current assets may be presented before or after current assets, and within the current assets cash can be presented as the first or the last line item. However, the standard stipulates the following list of minimum line items that are sufficiently different in nature or function to justify separate presentation in the statement:

1. Property, plant and equipment;
2. Investment property;
3. Intangible assets;
4. Financial assets (excluding amounts shown under items 5, 8 and 9);
5. Investments accounted for using the equity method;
6. Biological assets;
7. Inventories;
8. Trade and other receivables;
9. Cash and cash equivalents;
10. The total of assets classified as held-for-sale and assets included in disposal groups classified as held-for-sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*;
11. Trade and other payables;
12. Provisions;
13. Financial liabilities (excluding amounts shown under items 11 and 12);
14. Liabilities and assets for current tax, as defined in IAS 12, *Income Taxes*;
15. Deferred tax liabilities and deferred tax assets, as defined in IAS 12;
16. Liabilities included in disposal groups classified as held-for-sale in accordance with IFRS 5;
17. Non-controlling interests, presented within equity; and
18. Issued capital and reserves attributable to owners of the parent.

The format of the statement of financial position as illustrated by the appendix to IAS 1 is similar to the following:

**Exemplum Reporting PLC**  
**Consolidated Statement of Financial Position**  
**as at 31 December 20XX**

	<u>20XX</u>	<u>20XX-1</u>
<b>Assets</b>		
<i>Non-current assets:</i>		
Property, plant and equipment	X	X
Investment property	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments accounted for using the equity method	X	X
Deferred income tax assets	X	X
Available-for-sale investments	X	X
Other financial assets	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<i>Current assets:</i>		
Inventories	<u>X</u>	<u>X</u>
Trade receivables	<u>X</u>	<u>X</u>
Other current assets	<u>X</u>	<u>X</u>
Other financial assets	<u>X</u>	<u>X</u>
Cash and cash equivalents	<u>X</u>	<u>X</u>
	X	X
Non-current assets held for sale	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<b>Liabilities</b>		
<i>Current liabilities</i>		
Trade and other payables	X	X
Current borrowings	X	X
Current portion of long-term borrowings	X	X
Current tax payable	X	X
Finance lease liabilities	X	X
Current provisions	<u>X</u>	<u>X</u>
	X	X
Liabilities of a disposal group classified as held for sale	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<b>Net current assets</b>	<u>X</u>	<u>X</u>
<i>Non-current liabilities</i>		
Non-current borrowings	X	X
Deferred tax	X	X
Finance lease liabilities	X	X
Non-current provisions	X	X
Retirement benefit obligations	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<b>Net assets</b>	<u>X</u>	<u>X</u>
<b>Equity applicable to equity holders of the parent</b>		
Ordinary shares	X	X
Share premium	X	X
Translation reserve	X	X
Fair value reserve	X	X
Retained earnings	<u>X</u>	<u>X</u>
<b>Equity attributable to owners of the parent</b>	X	X
<b>Non-controlling interest</b>	<u>X</u>	<u>X</u>
<b>Total equity</b>	<u>X</u>	<u>X</u>



## CLASSIFICATION OF ASSETS

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Assets, liabilities and equity are presented separately in the statement of financial position. In accordance with IAS 1, companies should make a distinction between current and non-current assets and liabilities, except when a presentation based on liquidity provides information that is more reliable or relevant. As a practical matter, the liquidity exception is primarily invoked by banks and some other financial organizations, for which fixed investments (e.g., in property and equipment) are dwarfed by financial instruments and other assets and liabilities.

### Current Assets

An asset should be classified as a current asset when it satisfies any one of the following:

1. It is expected to be realized in, or is held for sale or consumption in, the normal course of the entity's operating cycle;
2. It is held primarily for trading purposes;
3. It is expected to be realized within 12 months of the end of the reporting period;
4. It is cash or a cash equivalent asset that is not restricted in its use.

If a current asset category includes items that will have a life of more than 12 months, the amount that falls into the next financial year should be disclosed in the notes. All other assets should be classified as non-current assets, if a classified statement of financial position is to be presented in the financial statements.

Thus, current assets include cash, cash equivalents and other assets that are expected to be realized in cash, or sold or consumed during one normal operating cycle of the business. The operating cycle of an entity is the time between the acquisition of materials entering into a process and its realization in cash or an instrument that is readily convertible into cash. Inventories and trade receivables should still be classified as current assets in a classified statement of financial position even if these assets are not expected to be realized within 12 months from the end of the reporting period. However, marketable securities could only be classified as current assets if they are expected to be realized (sold, redeemed or matured) within 12 months after the end of the reporting period, even though most would deem marketable securities to be more liquid than inventories and possibly even than receivables. Management intention takes priority over liquidity potential. The following items would be classified as current assets:

1. **Inventories** held either for sale in the ordinary course of business or in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the rendering of services (IAS 2). The basis of valuation and the method of pricing, which is limited to FIFO or weighted-average cost, should be disclosed.

Inventories—at the lower of cost (FIFO) or net realizable value      xxx

In the case of a manufacturing concern, raw materials, work in process and finished goods should be disclosed separately on the statement of financial position or in the footnotes.

Inventories:

Finished goods	xxx	
Work in process	xxx	
Raw materials	<u>xxx</u>	xxx

2. **Receivables** include accounts and notes receivable, receivables from affiliate companies, and officer and employee receivables. The term accounts receivable represents amounts due from customers arising from transactions in the ordinary course of business. Allowances due to expected lack of collectibility and any amounts discounted or pledged should be stated clearly. The allowances may be based on a relationship to sales or based on direct analysis of the receivables. If material, the receivables should be analysed into their component parts. The receivables section may be presented as follows:

Receivables:

Customer accounts	xxx		
Customer notes/commercial paper	<u>xxx</u>	xxx	
Less allowance for doubtful accounts		<u>(xxx)</u>	
			xxx
Due from associated companies			<u>xxx</u>
Due from officers and employees			<u>xxx</u>
Total			xxx

3. **Prepaid expenses** are assets created by the prepayment of cash or incurrence of a liability. They expire and become expenses with the passage of time, use, or events (e.g., prepaid rent, prepaid insurance and deferred taxes). This item is frequently aggregated with others on the face of the statement of financial position with details relegated to the notes, since it is rarely a material amount.
4. **Trading investments** are those that are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. A financial asset should be classified as held-for-trading if it is part of a portfolio for which there is evidence of a recent actual pattern of short-term profit making. Trading assets include debt and equity securities and loans and receivables acquired by the entity with the intention of making a short-term profit. Derivative financial assets are always deemed held-for-trading unless they are designated as effective hedging instruments.

As required by IAS 39, a financial asset held for trading should be measured at fair value, with changes in value reflected currently in profit and loss. There is a presumption that fair value can be reliably measured for financial assets that are held for trading.

5. **Cash** and cash equivalents include cash on hand, consisting of coins, notes and undeposited cheques; money orders and drafts; and deposits in banks. Anything accepted by a bank for deposit would be considered cash. Cash must be available for a demand withdrawal; thus, assets such as certificates of deposit would not be considered cash because of the time restrictions on withdrawal. Also, to be classified as a current asset, cash must be available for current use. According to IAS 1, cash that is restricted in use and whose restrictions will not expire within the operating cycle, or cash restricted for a non-current use, would not be included in current assets. According to IAS 7, cash equivalents include short-term, highly liquid investments that (1) are readily convertible to known amounts of cash, and (2) are so near their maturity (original maturities of three months or less) that they present negligible risk of changes in value because of changes in interest rates. Treasury bills, commercial paper and money market funds are all examples of cash equivalents.

**Non-Current Assets**

IAS 1 uses the term “non-current” to include tangible, intangible, operating and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions, as long as the meaning is clear. Non-current assets include:

- Held-to-maturity investments;
- Investment property;
- Property, plant and equipment;
- Intangible assets;
- Assets held for sale; and
- Miscellaneous other assets.

**Other Assets**

An all-inclusive heading for accounts that do not fit neatly into any of the other asset categories (e.g., long-term deferred expenses that will not be consumed within one operating cycle, and deferred tax assets).

**CLASSIFICATION OF LIABILITIES**

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The liabilities are normally displayed in the statement of financial position in the order of payment due dates.

**Current Liabilities**

According to IAS 1, a liability should be classified as a current liability when:

1. It is expected to be settled in the normal course of business within the entity’s operating cycle;
2. It is due to be settled within 12 months of the date of the statement of financial position;
3. It is held primarily for the purpose of being traded; or
4. The entity does not have an unconditional right to defer settlement beyond 12 months. Note that the terms of a liability that could at the option of the counterparty result in its settlement by the issue of equity instruments do not affect its classification.

Financial assets and financial liabilities that are classified as held for trading in accordance with IAS 39 need not necessarily be presented as current assets or current liabilities.

All other liabilities should be classified as non-current liabilities. Obligations that are due on demand or are callable at any time by the lender are classified as current regardless of the present intent of the entity or of the lender concerning early demand for repayment. Current liabilities also include:

1. Obligations arising from the acquisition of goods and services entering into the entity’s normal operating cycle (e.g., accounts payable, short-term notes payable, wages payable, taxes payable and other miscellaneous payables);
2. Collections of money in advance for the future delivery of goods or performance of services, such as rent received in advance and unearned subscription revenues;
3. Other obligations maturing within the current operating cycle, such as the current maturity of bonds and long-term notes.

Certain liabilities, such as trade payables and accruals for operating costs, which form part of the working capital used in the normal operating cycle of the business, are to be classified as current liabilities even if they are due to be settled more than 12 months from the date of the statement of financial position.

Other current liabilities which are not settled as part of the operating cycle, but which are due for settlement within 12 months of the date of the statement of financial position, such as dividends payable and the current portion of long-term debt, should also be classified as current liabilities. However, interest-bearing liabilities that provide the financing for working capital on a long-term basis and are not scheduled for settlement within 12 months should not be classified as current liabilities.

IAS 1 provides another exception to the general rule that a liability due to be repaid within 12 months from the end of the reporting period should be classified as a current liability. If the original term was for a period longer than 12 months and the entity intended to refinance the obligation on a long-term basis prior to the date of the statement of financial position, and that intention is supported by an agreement to refinance, or to reschedule payments, which is completed before the financial statements are approved, then the debt is to be reclassified as non-current as of the date of the statement of financial position.

However, an entity would continue to classify as current liabilities its long-term financial liabilities when they are due to be settled within 12 months, if an agreement to refinance on a long-term basis was made after the date of the statement of financial position. Similarly if long-term debt becomes callable as a result of a breach of a loan covenant, and no agreement with the lender to provide a grace period of more than 12 months has been concluded by the date of the statement of financial position, the debt must be classified as current.

The distinction between current and non-current liquid assets generally rests upon both the ability and the intent of the entity to realize or not to realize cash for the assets within the traditional one-year concept. Intent is not of similar significance with regard to the classification of liabilities, however, because the creditor has the legal right to demand satisfaction of a currently due obligation, and even an expression of intent not to exercise that right does not diminish the entity's burden should there be a change in the creditor's intention. Thus, whereas an entity can control its use of current assets, it is limited by its contractual obligations with regard to current liabilities, and accordingly, accounting for current liabilities (subject to the two exceptions noted above) is based on legal terms, not expressions of intent.

### **Non-Current Liabilities**

Obligations that are not expected to be settled within the current operating cycle, including:

1. Obligations arising as part of the long-term capital structure of the entity, such as the issuance of bonds, long-term notes and lease obligations;
2. Obligations arising out of the normal course of operations, such as pension obligations, decommissioning provisions and deferred taxes; and
3. Contingent obligations involving uncertainty as to possible expenses or losses. These are resolved by the occurrence or non-occurrence of one or more future events that confirm the amount payable, the payee, and/or the date payable. Contingent obligations include such items as product warranties (see the section on provisions below).

For all long-term liabilities, the maturity date, nature of obligation, rate of interest and description of any security pledged to support the agreement should be clearly shown. Also,

in the case of bonds and long-term notes, any premium or discount should be reported separately as an addition to or subtraction from the par (or face) value of the bond or note. Long-term obligations which contain certain covenants that must be adhered to are classified as current liabilities if any of those covenants have been violated and the lender has the right to demand payment. Unless the lender expressly waives that right or the conditions causing the default are corrected, the obligation is current.

### **Offsetting Assets and Liabilities**

In general, assets and liabilities may not be offset against each other. However, the reduction of accounts receivable by the allowance for doubtful accounts, or of property, plant and equipment by the accumulated depreciation, are acts that reduce these assets by the appropriate valuation accounts and are not considered to be the result of offsetting assets and liabilities.

Only where there is an actual right of setoff is the offsetting of assets and liabilities a proper presentation. This right of setoff exists only when all the following conditions are met:

1. Each of the two parties owes the other determinable amounts (although they may be in different currencies and bear different rates of interest).
2. The entity has the right to set off against the amount owed by the other party.
3. The entity intends to offset.
4. The right of setoff is legally enforceable.

In particular cases, laws of certain countries, including some bankruptcy laws, may impose restrictions or prohibitions against the right of setoff. Furthermore, when maturities differ, only the party with the nearest maturity can offset because the party with the longer maturity must settle in the manner determined by the earlier maturity party.

The question of setoff is sometimes significant for financial institutions which buy and sell financial instruments, often repackaging them as part of the process. IAS 39 provides detailed rules for determining when derecognition is appropriate and when assets and liabilities must be retained on the statement of financial position.

## **CLASSIFICATION OF SHAREHOLDERS' EQUITY**

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Shareholders' equity represents the interests of the owners in the net assets of a corporation. It shows the cumulative net results of past transactions and other events affecting the entity since its inception.

### **Share Capital**

This consists of the par or nominal value of preference and ordinary shares. The number of shares authorized, the number issued, and the number outstanding should be clearly shown. For preference share capital, the preference features must also be stated, as the following example illustrates:

6% cumulative preference shares, \$100 par value, callable at \$115, 15,000 shares authorized, 10,000 shares issued and outstanding	\$1,000,000
Ordinary shares, \$10 par value per share, 2,000,000 shares authorized, 1,500,000 shares issued and outstanding	\$15,000,000

Preference share capital that is redeemable at the option of the holder should not be treated as a part of equity—rather, it should be reported as a liability. IAS 32 makes it clear that substance prevails over form in the case of compound financial instruments; any instrument which includes a contractual obligation for the entity to deliver cash is considered to be a liability.

### **Retained Earnings**

This represents the accumulated earnings since the inception of the entity, less any earnings distributed to owners in the form of dividends. In some jurisdictions, notably in continental Europe, the law requires that a portion of retained earnings, equivalent to a small proportion of share capital, be set aside as a legal reserve. Historically, this was intended to limit dividend distributions by young or ailing businesses. This practice is expected to wane, and in any event is not congruent with financial reporting in accordance with IFRS and with the distinction made between equity and liabilities.

Also included in the equity section of the statement of financial position is treasury stock representing issued shares that have been reacquired by the issuer, in jurisdictions where the purchase of the entity's own shares is permitted by law. These shares are generally stated at their cost of acquisition, as a reduction from shareholders' equity.

Finally, some elements of comprehensive income, the components of other comprehensive income, are reported in equity. These components of other comprehensive income include net changes in the fair values of available-for-sale securities portfolios, and unrealized gains or losses on translations of the financial statements of subsidiaries denominated in a foreign currency, net changes in revaluation surplus, actuarial gains and losses on defined benefit plans, and the effective portion of gains and losses on hedging instruments in a cash flow hedge. In accordance with the revised IAS 1, net changes in all items of other comprehensive income should be reported in a new statement called "statement of profit or loss and other comprehensive income," and accumulated balances in these items are reported in equity. (For a detailed discussion on statement of profit or loss and other comprehensive income, refer to Chapter 5.)

**Non-controlling interests** should be shown separately from owners' equity of the parent company in group accounts (i.e., consolidated financial statements), but are included in the overall equity section.

### **Disclosure of Share Capital**

An entity is required to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies, and processes for managing capital. This information should include a description of what it manages as capital, the nature of externally imposed capital requirements, if there are any, as well as how those requirements are incorporated into the management of capital. Additionally, summary quantitative data about what it manages as capital should be provided as well as any changes in the components of capital and methods of managing capital from the previous period. The consequences of non-compliance with externally imposed capital requirements should also be included in the notes. All these disclosures are based on the information provided internally to key management personnel.

An entity should also present either in the statement of financial position or in the statement of changes in equity, or in the notes, disclosures about each class of share capital as well as about the nature and purpose of each reserve within equity. Information about share

capital should include the number of shares authorized and issued (fully paid or not fully paid); par value per share or that shares have no par value; the rights, preferences and restrictions attached to each class of share capital; shares in the entity held by the entity (treasury shares) or by its subsidiaries or associates; and shares reserved for issue under options and contracts (including terms and amounts).

## **FUTURE DEVELOPMENTS**

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On May 28, 2015 the IASB published an Exposure Draft containing a proposed revised conceptual framework. Details of the proposed revisions are given in Chapter 2.

## **US GAAP COMPARISON**

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Comparative statements are encouraged but not required by US GAAP. The SEC requires balance sheets for two years.

The balance sheet is usually presented in order of most liquid or current to least. This is usually the opposite of the order in IFRS. US GAAP contains captions for long-term assets and long-term liabilities. The SEC calls for display of a total for current assets and a total for current liabilities, where appropriate, and public companies must comply with the detailed layout requirements of Regulation S-X.

Non-current debt that matures within one year can be classified as non-current if the entity has the intent and ability to refinance the obligation on a long-term basis. Evidence of intent includes:

- Entering into a refinancing agreement for a term of greater than one year, completed before the financial statements are issued or available to be issued, or
- Issuing long-term debt or equity with the purpose of refinancing the short-term debt before the financial statements are issued or available to be issued.

Debt for which there has been a covenant violation may be classified as non-current, if there is a lender agreement to waive the right to demand repayment for more than one year and that agreement exists before the financial statements are issued or available to be issued.

Current portions of deferred tax assets and liabilities must be shown as current. The term “reserve” is discouraged in US GAAP.

comprehensive income. Components of comprehensive income are not permitted to be presented in the statement of changes in equity as a combined statement of income and comprehensive income became mandatory (or at least preferable); this represented a triumph of the *all-inclusive concept* of performance reporting. While this approach has been officially endorsed by world standard setters for many decades, in fact many standards promulgated over the years (e.g., IAS 39 requiring the exclusion of temporary changes in the fair value of investments other than trading securities from current income) have deviated from adherence to this principle. While IAS 1 encourages the presentation of comprehensive income in a single statement, with net income being an intermediate caption, it remains acceptable to instead report in a two-statement format, with a separate income statement and a separate statement of comprehensive income. The statement of comprehensive income will report all non-owner changes in equity separately from owner changes in equity (investments by or distributions to owners).

IAS 1 in its current incarnation thus marks a notable return to an all-inclusive concept of performance reporting, which had been eroded in recent decades as items such as unrealized gains and losses on available-for-sale investments and defined benefit plan actuarial gains or losses became reportable directly in the equity section of the statement of financial position—a practice which generated understandable confusion regarding the identity of the reporting entity’s “real” results of operations.

Concepts of performance and measures of income have changed over the years, and current reporting still largely focuses on *realized* income and expense. However, *unrealized* gains and losses also reflect real economic transactions and events and are of great interest to decision makers. Under current IFRS, some of these unrealized gains and losses are *recognized*, while others are *unrecognized*. Both the financial reporting entities themselves and the financial analyst community go to great lengths to identify those elements within reported income which are likely to be continuing into the future, since expected earnings and cash flows of future periods are main drivers of share prices.

IFRS rules for the presentation of income are based on a so-called “mixed attribute model.” It thus reflects a mixture of traditional realized income reporting, accompanied by fair value measures applied to unrealized gains and losses meeting certain criteria (e.g., financial instruments are accounted for differently from plant assets). For example, unrealized gains and losses arising from the translation of the foreign currency-denominated financial statements of foreign subsidiaries do not flow through the income statement. IAS 1 requires that all owner changes in equity should be reported separately from non-owner changes (deriving from performance), in a separate *statement of changes in equity*.

The traditional income statement has been known by many titles. IFRS refer now to this statement as the statement of profit or loss, which reports all items entering into the determination of periodic earnings, but excluding other comprehensive income items which are reported in the other comprehensive income section of the comprehensive statement of profit or loss and other comprehensive income.

For many years, the income statement had been widely perceived by investors, creditors, management and other interested parties as the single most important part of an entity’s basic financial statements. In fact, beginning in the mid-twentieth century, accounting theory development was largely driven by the desire to present a meaningful income statement, even to the extent that the balance sheet sometimes became the repository for balances of various accounts, such as deferred charges and credits, which could scarcely meet any reasonable



definitions of assets or liabilities. This was done largely to serve the needs of investors, who are commonly thought to use the past income of a business as the most important input to their predictions for entities' future earnings and cash flows, which in turn form the basis for their predictions of future share prices and dividends.

Creditors look to statement of profit or loss for insight into the borrower's ability to generate the future cash flows needed to pay interest and eventually to repay the principal amounts of the obligations. Even in the instance of secured debt, creditors do not look primarily to the statement of financial position (balance sheet), inasmuch as the seizure and liquidation of collateral is never the preferred route to recovery of the lender's investment. Rather, generation of cash flows from operations—which is generally closely correlated to income—is seen as the primary source for debt service.

Management, then, must be concerned with the statement of profit or loss by virtue of the importance placed on it by investors and creditors. In many large corporations, senior management receive substantial bonuses relating to either profit targets or share price performance. Consequently, management sometimes devote considerable efforts to massaging what appears in the income statement, in order to present the most encouraging view of the reporting entity's future prospects. This means that standard setters need to bear in mind the abuse possibilities of the rules they impose and, for that matter, the rules have been imposed in response to previous financial reporting abuses.

The importance placed on income measurement has, as is well known, influenced behaviour by some management personnel, who have sought to manipulate results to, say, meet Wall Street earnings estimates. The motivation for this improper behaviour is readily understandable when one observes that recent markets have severely punished companies that missed earnings estimates by as little as a penny per share. One very popular vehicle for earnings management has centered on revenue recognition. Historically, certain revenue recognition situations, such as that involving prepaid service revenue, have lacked specific financial reporting rules or have been highly subject to interpretation, opening the door to aggressive accounting by some entities. While in many businesses the revenue earning cycle is simple and straightforward and therefore difficult to manipulate, there are many other situations where it is a matter of interpretation as to when the revenue has actually been earned. Examples have included recognition by lessors of lease income from long-term equipment rental contracts that were bundled with supplies and maintenance agreements, and accruals of earnings on long-term construction contracts or software development projects having multiple deliverables.

The information provided by the statement of profit or loss, relating to individual items of income and expense, as well as to the relationships between and among these items (such as the amounts reported as gross margin or profit before interest and taxes), facilitates financial analysis, especially that relating to the reporting entity's historical and possible future profitability. Even with the ascendancy of the statement of financial position as the premier financial statement, financial statement users will always devote considerable attention to the statement of profit or loss.

Further to the 2007 revisions to IAS 1, in 2011 and 2012 the IASB made additional amendments. In June 2011 the IASB issued an amendment to IAS 1 titled *Presentation of Items of Other Comprehensive Income*, which became effective for accounting periods beginning on or after July 1, 2012. The amendment improves the consistency and clarity of items recorded in other comprehensive income. Other comprehensive income is grouped together on the basis of whether or not items are subsequently reclassified to profit or loss.

The Board highlighted the importance of presenting profit or loss and other comprehensive income together and with equal prominence. The name of the *statement of comprehensive income* is changed to *statement of profit or loss and other comprehensive income*.

In May 2012, the IASB issued “Annual Improvements 2009–2011 cycle,” a collection of amendments to IFRS in response to issues addressed during the 2009–2011 cycle. The IASB became aware of diversity in views as to the requirements for comparative information when an entity provides individual financial statements beyond the minimum comparative information requirements of IAS 1 and thus issued these amendments to IAS 1 in order to clarify the requirements for comparative information. These amendments became effective for periods beginning on or after January 1, 2013.

<b>Sources of IFRS</b>		
<i>Conceptual Framework for Financial Reporting 2010</i>		
IAS 1, 14, 16, 18, 19, 21, 36, 37, 38, 39, 40	IFRS 1, 5	SIC 29

## FUTURE DEVELOPMENTS

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In May 2014 the IASB published IFRS 15 *Revenue from Contracts with Customers*, which was intended at the time to be effective for accounting periods commencing on or after January 1, 2017. Following a decision by the FASB to defer the implementation of IFRS 15 by a year to be effective for accounting periods commencing on or after January 1, 2018, the IASB has issued an Exposure Draft proposing the same change. When effective, IFRS 15 will replace IAS 11 *Construction Contracts* and IAS 18 *Revenue*.

On May 28, 2015 the IASB published an Exposure Draft containing a proposed revised conceptual framework. Details of the proposed revisions are given in Chapter 2.

## SCOPE

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This chapter focuses on key income measurement issues and on matters of comprehensive income, statement presentation and disclosure. It also explains and illustrates the presentation of the *statement of profit or loss and other comprehensive income* and the *statement of changes in equity*. The chapter incorporates information from the *Conceptual Framework for Financial Reporting 2010*, IAS 1, and other standards.

## DEFINITIONS OF TERMS

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### Elements of Financial Statements

**Expenses.** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring liabilities that result in decreases in equity, other than those relating to distributions to equity participants. The term *expenses* is broad enough to include *losses* as well as normal categories of expenses; thus, IFRS differs from the corresponding US GAAP standard, which deems losses to be a separate and distinct element to be accounted for, denoting decreases in equity from peripheral or incidental transactions.

**Income.** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets that result in increases in equity, other than those relating

to contributions from equity participants. The IASB's *Framework* clarifies that this definition of income encompasses both revenue and gains. As with expenses and losses, the corresponding US accounting standard holds that revenues and gains constitute two separate elements of financial reporting, with gains denoting increases in equity from peripheral or incidental transactions.

**Other comprehensive income.** Items of income and expense (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRS. The components of other comprehensive income include (1) changes in revaluation surplus (IAS 16 and 38); (2) actuarial gains and losses on defined benefit plans (IAS 19); (3) translation gains and losses (IAS 21); (4) gains and losses on remeasuring available-for-sale financial assets (IAS 39); and (5) the effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

**Profit or loss.** The total of income less expenses, excluding the components of other comprehensive income.

**Reclassification adjustments.** Amounts reclassified to profit or loss in the current period that were recognized in other comprehensive income in the current or preceding periods.

**Statement of changes in equity.** As prescribed by IAS 1, an entity should present, as a separate financial statement, a statement of changes in equity showing:

1. Total comprehensive income for the period (reporting separately amounts attributable to owners of the parent and to non-controlling interest);
2. For each component of equity, the effect of retrospective application or retrospective restatement recognized in accordance with IAS 8;
3. The amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners; and
4. A reconciliation for each component of equity (each class of share capital and each reserve) between the carrying amounts at the beginning and the end of the period, separately disclosing each movement.

**Statement of profit or loss and other comprehensive income.** The statement of profit or loss and other comprehensive income presents all components of "profit or loss" and "other comprehensive income" in a single statement, with net income being an intermediate caption. Alternatively, IAS 1 permits the use of a two-statement format, with a separate statement of profit or loss and a separate statement of comprehensive income.

**Total comprehensive income.** The change in equity (net assets) of an entity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in net assets during a period, except those resulting from investments by owners and distributions to owners. It comprises all components of "profit or loss" and "other comprehensive income" presented in the statement of comprehensive income.

## Other Terminology

**Discontinued operations.** IFRS 5 defines a "discontinued operation" as a component of an enterprise that has been disposed of, or is classified as held-for-sale: and

1. Represents a separate major line of business or geographical area of operations;
2. Is part of a single coordinated disposal plan;
3. Is a subsidiary acquired exclusively with a view to resale.

**Component of an entity.** In the context of discontinued operations, IFRS 5 currently defines a component of an entity as operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity—a cash-generating unit, or group of cash-generating units.

**Net assets.** Net assets are total assets minus total liabilities (which is thus equivalent to owners' equity).

**Realization.** The process of converting non-cash resources and rights into money, or more precisely, the sale of an asset for cash or claims to cash.

**Recognition.** The process of formally recording or incorporating in the financial statements of an entity items that meet the definition of an element and satisfy the criteria for recognition.

**Operating segment.** A component of an entity (1) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); (2) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and (3) for which discrete financial information is available.

**Minimum comparative information.** Narrative and descriptive information in respect of the preceding period for all amounts reported in the current period's financial statements where it is relevant to understanding of the current period's financial statements.

**Additional comparative information.** Narrative and descriptive comparative information in addition to the minimum comparative financial statements required by IFRS.

## CONCEPTS OF INCOME

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Economists have generally employed a wealth maintenance concept of income. Under this concept, income is the maximum amount that can be consumed during a period and still leave the entity with the same amount of wealth at the end of the period as existed at the beginning. Wealth is determined with reference to the current market values of the net productive assets at the beginning and end of the period. Therefore, the economists' definition of income would fully incorporate market value changes (both increases and decreases in wealth) in the determination of periodic income and this would correspond to measuring assets and liabilities at fair value, with the net of all the changes in net assets equating to comprehensive income.

Accountants, on the other hand, have traditionally defined income by reference to specific transactions that give rise to recognizable elements of revenue and expense during a reporting period. The events that produce reportable items of revenue and expense comprise a subset of economic events that determine economic income. Many changes in the market values of wealth components are deliberately excluded from the measurement of accounting income but are included in the measurement of economic income, although those exclusions have grown fewer as the use of fair values in financial reporting has been more widely embraced in recent years.

This can be seen in IAS 39, where the changes in market value of some financial instruments are recognized, and in IAS 41, where the change in value of biological assets is recognized although not realized.

## RECOGNITION AND MEASUREMENT

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### *Income*

According to the IASB's conceptual framework:

*Income is increases 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. The definition of income encompasses both revenue and gains, and revenue arises in the course of ordinary activities of an enterprise and is referred to by different names, such as sales, fees, interest, dividends, royalties, and rent.*

IAS 18 is the standard which currently deals with the accounting for revenue. It says that revenue is the gross inflow of economic benefits during the period (excluding transactions with owners). IAS 18 will be replaced by IFRS 15 with effect for accounting periods commencing on or after January 1, 2017, although at the time of writing the IASB is consulting on deferring this by a year. IFRS 15 states that revenue is income arising in the course of an entity's ordinary activities.

The measurement basis under IAS 18 is that revenue be measured at the fair value of the consideration received or receivable. In accordance with IFRS 13, *Fair Value* is defined as

*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

The historical cost measurement basis involves recognizing a completed marketplace transaction, in other words measuring at fair value at initial recognition.

IFRS 15 will require that when (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price that is allocated to that performance obligation, and goes on to set out detailed requirements for determining the transaction price.

Revenue recognition is discussed in detail in Chapter 20.

### *Expenses*

According to the IASB's conceptual framework:

*Expenses are decreases in economic benefits during an 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.*

Expenses are expired costs, or items that were assets but are no longer assets because they have no future value.

Costs such as materials and direct labour consumed in the manufacturing process are relatively easy to identify with the related revenue elements. These cost elements are included in inventory and expensed as cost of sales when the product is sold and revenue from the sale is recognized. This is associating cause and effect.

Some costs are more closely associated with specific accounting periods. In the absence of a cause and effect relationship, the asset's cost should be allocated to the benefited accounting periods in a systematic and rational manner. This form of expense recognition involves assumptions about the expected length of benefit and the relationship between benefit and cost of each period. Depreciation of fixed assets, amortization of intangibles, and allocation of rent and insurance are examples of costs that would be recognized by the use of a systematic and rational method.

All other costs are normally expensed in the period in which they are incurred. This would include those costs for which no clear-cut future benefits can be identified, costs that were recorded as assets in prior periods but for which no remaining future benefits can be identified, and those other elements of administrative or general expense for which no rational allocation scheme can be devised. The general approach is first to attempt to match costs with the related revenues. Next, a method of systematic and rational allocation should be attempted. If neither of these measurement principles is beneficial, the cost should be immediately expensed.

### ***Gains and losses***

The conceptual framework defines the term *expenses* broadly enough to include losses. IFRS include no definition of gains and losses that enables them to be separated from income and expense. Traditionally, gains and losses are thought by accountants to arise from purchases and sales outside the regular business trading of the company, such as on disposals of non-current assets that are no longer required. IAS 1 used to include an extraordinary category for display of items that were clearly distinct from ordinary activities. The IASB removed this category in its 2003 Improvements Project, concluding that these items arose from the normal business risks faced by an entity and that it is the nature or function of a transaction or other event, rather than its frequency, that should determine its presentation within the statement of comprehensive income.

According to the IASB's *Framework*:

*Gains (losses) represent increases (decreases) in economic benefits and as such are no different in nature from revenue (expenses). Hence they are not regarded as separate elements in IASB's Framework. Characteristics of gains and losses include the following:*

1. *Result from peripheral transactions and circumstances that may be beyond entity's control.*
2. *May be classified according to sources or as operating and non-operating.*

## **STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

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IAS 1 states that comprehensive income is the change in the entity's net assets over the course of the reporting period arising from non-owner sources. An entity has the option of presenting comprehensive income in a period either in one statement (the single-statement approach) or in two statements (the two-statement approach). The IASB initially intended to introduce the single-statement approach for the statement of comprehensive income, but during discussions with constituents, many of them were opposed to the concept of a single statement, stating that it could result in undue focus on the "bottom line" of the statement. Consequently, the IASB decided that presentation in a single statement was not as important as its fundamental decision that all non-owner changes in equity should be presented separately from owner changes in equity. However, the IASB prefers a one-statement approach. If an entity presents the components of profit or loss in a separate statement, this separate statement of profit or loss (income statement) forms part of a complete set of financial statements and should be displayed immediately before the statement of comprehensive income.

Although IAS 1 uses the terms “profit or loss,” “other comprehensive income” and “total comprehensive income,” an entity may use other terms to describe the totals, as long as the meaning is clear. For example, an entity may use the term “net income” to describe profit or loss.

Comprehensive income comprises all components of “profit or loss” and of “other comprehensive income.”

An entity has a choice of presenting all components of comprehensive income recognized in a period either:

1. In a single statement of profit or loss and other comprehensive income, in which all items of income and expense are recognized in the period (the single-statement approach); or
2. In two statements (the two-statement approach):
  - a. A statement displaying components of profit or loss (separate statement of profit or loss);
  - b. A second statement beginning with profit or loss and displaying components of other comprehensive income.

Total comprehensive income for the period reported in a statement of profit or loss and other comprehensive income is the total of all items of income and expense recognized during the period (including the components of profit or loss and other comprehensive income).

Other comprehensive income is the total of income less expenses (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRS or Interpretations.

The components of *other comprehensive income* comprise:

1. Changes in revaluation surplus (see IAS 16, *Property, Plant and Equipment*, and IAS 38, *Intangible Assets*);
2. Remeasurements of defined benefit plans (see IAS 19, *Employee Benefits*);
3. Gains and losses arising from translating the financial statements of foreign operation (see IAS 21, *The Effects of Changes in Foreign Exchange Rates*);
4. Gains and losses on remeasuring available-for-sale financial assets (see IAS 39, *Financial Instruments: Recognition and Measurement*);
5. The effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39, *Financial Instruments: Recognition and Measurement*).

The statement of profit and loss and other comprehensive income must in addition to the profit and loss and other comprehensive section disclose the following totals:

1. Profit and loss;
2. Total other comprehensive income;
3. Comprehensive income for the year (total of 1. and 2.).

IAS 1 stipulates that, in addition to items required by other IFRS, the profit and loss section of the statement of profit or loss must include line items that present the following amounts for the period (if they are pertinent to the entity’s operations for the period in question):

1. Revenue;
2. Finance costs;

3. Share of the profit or loss of associates and joint ventures accounted for by the equity method;
4. Tax expense;
5. A single amount for the total of discontinued operations.

In addition, an entity should disclose the following items on the face of the statement of profit or loss and other comprehensive income as allocations of:

1. Profit or loss for the period attributable to:
  - a. Non-controlling interest; and
  - b. Owners of the parent.
2. Total comprehensive income for the period attributable to:
  - a. Non-controlling interest; and
  - b. Owners of the parent.

Items 1–5 listed above and disclosure of profit or loss attributable to non-controlling interest and owners of the parent (listed in 1.) can be presented on the face of a separate statement of profit or loss (income statement).

The foregoing items represent the barest minimum of acceptable detail in the statement of comprehensive income: the standard states that additional line items, headings, and subtotals should be presented on the face of the statement when this is relevant to an understanding of the entity's financial performance. This requirement cannot be dealt with by incorporating the items into the notes to the financial statements. When items of income or expense are material, disclosures segregating their nature and amount are required in the statement of comprehensive income or in the notes.

## **PRESENTATION IN THE PROFIT OR LOSS SECTION**

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In accordance with IAS 1, if an entity presents the components of profit or loss in a separate statement of profit or loss, this separate statement should be displayed immediately before the statement of comprehensive income. The following also needs to be disclosed:

### ***Statement title***

The legal name of the entity must be used to identify the financial statements and the correct title used to distinguish the statement from other information presented in the annual report.

### ***Reporting period***

The period covered by the statement of profit or loss must clearly be identified, such as “year ended December 31, 2014.” Or “six months ended September 30, 2014.” Income statements are normally presented annually (i.e., for a period of 12 months or a year). However, in some jurisdictions they may be required at quarterly or six-month intervals, and in exceptional circumstances (such as a newly acquired subsidiary harmonizing its account dates with those of its new parent), companies may need to prepare a statement of profit or loss for periods in excess of one year or for shorter periods as well. IAS 1 requires that when



financial statements are presented for periods other than a year, the following additional disclosures should be made:

1. The reason for presenting the statement of profit or loss (and other financial statements, such as the statement of cash flows, statement of changes in equity, and notes) for a period other than one year; and
2. The fact that the comparative information presented (in the statement of profit or loss, statement of changes in equity, statement of cash flows, and notes) is not entirely comparable.

Entities whose operations form a natural cycle may have a reporting period end on a specific day of the week (e.g., the last Friday of the month). Certain entities (typically retail enterprises) may prepare income statements for a fiscal period of fifty-two or fifty-three weeks instead of a year (thus, to always end on a day such as Sunday, on which no business is transacted, so that inventory may be taken). These entities should clearly state that the income statement has been presented, for instance, “for the fifty-two-week period ended March 30, 2014.” IAS 1 notes that it is unlikely that the financial statements thus presented would be materially different from those that would be presented for one full year.

In order that the presentation and classification of items in the statement of profit or loss be consistent from period to period, items of income and expenses should be uniform both with respect to appearance and categories from one time period through the next. If a decision is made to change classification schemes, the comparative prior period Financials should be restated to conform and thus to maintain comparability between the two periods being presented together. Disclosure must be made of this reclassification, since the earlier period financial statements being presented currently will differ in appearance from those nominally same statements presented in the earlier year.

### ***Comparative information***

The issue of the “Annual Improvements 2009–2011 cycle” in May 2012, clarifies the requirements for comparative information. These requirements require that as a minimum, comparative figures regarding the previous reporting period are included. These requirements apply for both the profit or loss section and the other comprehensive income section.

**Exemplum Reporting PLC**  
**Statement of Profit or Loss**  
**For the Year Ended 31 December 20XX**  
*(classification of expense by nature)*

Revenue			X
Other income			X
Changes in inventories of finished goods and work in progress	X		
Work performed by the entity and capitalized	X		
Raw material and consumables used	X		
Employee benefits expense	X		
Depreciation and amortization expense	X		
Impairment of property, plant and equipment	X		
Other expenses	<u>X</u>		
Total expenses			<u>X</u>
Operating profit			X

An example of the income statement (profit or loss) classification by the “function of expense” method is as follows:

<b>Statement of Profit or Loss</b>	
<b>For the Year Ended 31 December 20XX</b>	
<i>(classification of expense by function)</i>	
Revenue	X
Cost of sales	<u>X</u>
Gross profit	<u>X</u>
Other income	X
Distribution costs	X
Administrative expenses	X
Other expenses	<u>X</u>
Operating profit	<u>X</u>

Under the “function of expense” method an entity should report, at a minimum, its cost of sales separately from other expenses. This method can provide more relevant information to the users of the financial statements than the classification under the “nature of expense” method, but allocating costs to functions may require arbitrary allocations based on judgement.

IAS 1 furthermore stipulates that if a reporting entity discloses expenses by function, it must also provide information on the nature of the expenses, including depreciation and amortization and staff costs (salaries and wages). The standard does not provide detailed guidance on this requirement, but companies need only provide a note indicating the nature of the allocations made to comply with the requirement.

IFRS 5 governs the presentation and disclosures pertaining to discontinued operations. This is discussed later in this chapter.

While IAS 1 does not require the inclusion of subsidiary schedules to support major captions in the statement of income, it is commonly found that detailed schedules of line items are included in full sets of financial statements. These will be illustrated in the following section to provide a more expansive discussion of the meaning of certain major sections of the statement of income.

### ***Revenue***

Companies typically show their regular trading operations first and then present any items to which they wish to direct analysts’ attention.

1. **Sales or other operating revenues** are charges to customers for the goods and/or services provided to them during the period. This section of the statement of income should include information about discounts, allowances, and returns, to determine net sales or net revenues.
2. **Cost of goods sold** is the cost of the inventory items sold during the period. In the case of a merchandising firm, net purchases (purchases less discounts, returns, and allowances plus freight-in) are added to beginning inventory to obtain the cost of goods available-for-sale. From the cost of goods available-for-sale amount, the ending inventory is deducted to compute cost of goods sold.

<b>Example of schedule of cost of goods sold</b>
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**Exemplum Reporting PLC**  
**Schedule of Cost of Goods Sold**  
**For the Year Ended 31 December 20XX**

Beginning inventory				X
Add: Purchases		X		
Freight-in		X		
Cost of purchases		X		
Less: Purchase discounts	X			
Purchase returns and allowances	X	(X)		
Net purchases				X
Cost of goods available for sale				X
Less: Ending inventory				(X)
Cost of goods sold				X

A manufacturing enterprise computes the cost of goods sold in a slightly different way. Cost of goods manufactured would be added to the beginning inventory to arrive at cost of goods available-for-sale. The ending finished goods inventory is then deducted from the cost of goods available-for-sale to determine the cost of goods sold. Cost of goods manufactured is computed by adding to raw materials on hand at the beginning of the period the raw materials purchased during the period and all other costs of production, such as labour and direct overhead, thereby yielding the cost of goods placed in production during the period. When adjusted for changes in work in process during the period and for raw materials on hand at the end of the period, this results in the calculation of goods produced.

<b>Example of schedules of cost of goods manufactured and sold</b>
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**Exemplum Reporting PLC**  
**Schedule of Cost of Goods Manufactured**  
**For the Year Ended 31 December 20XX**

Direct materials inventory, January 1		X	
Purchases of materials (including freight-in and deducting purchase discounts)		<u>X</u>	
Total direct materials available		X	
Direct materials inventory, December 31		(X)	
Direct materials used			X
Direct labour			X
Factory overhead:			
Depreciation of factory equipment		X	
Utilities		X	
Indirect factory labour		X	
Indirect materials		X	
Other overhead items		<u>X</u>	X
Manufacturing cost incurred in 2015			X
Add: Work in process, January 1			X
Less: Work in process, December 31			(X)
Cost of goods manufactured			X

**Exemplum Reporting PLC**  
**Schedule of Cost of Goods Sold**  
**For the Year Ended 31 December 20XX**

Finished goods inventory, January 1	X
Add: Cost of goods manufactured	<u>X</u>
Cost of goods available for sale	<u>X</u>
Less: Finished goods inventory, December 31	(X)
Cost of goods sold	X

3. **Operating expenses** are primary recurring costs associated with central operations, other than cost of goods sold, which are incurred to generate sales. Operating expenses are normally classified into the following two categories:

- a. Distribution costs (or selling expenses);
- b. General and administrative expenses.

Distribution costs are those expenses related directly to the company's efforts to generate sales (e.g., sales salaries, commissions, advertising, delivery expenses, depreciation of store furniture and equipment, and store supplies). General and administrative expenses are expenses related to the general administration of the company's operations (e.g., officers and office salaries, office supplies, depreciation of office furniture and fixtures, telephone, postage, accounting and legal services, and business licenses and fees).

4. **Other revenues and expenses** are incidental revenues and expenses not related to the central operations of the company (e.g., rental income from letting parts of premises not needed for company operations).
5. **Separate disclosure items** are items that are of such size, nature or incidence that their disclosure becomes important in order to explain the performance of the enterprise for the period. Examples of items that, if material, would require such disclosure are as follows:
  - a. Write-down of inventories to net realizable value, or of property, plant and equipment to recoverable amounts, and subsequent reversals of such write-downs;
  - b. Costs of restructuring the activities of an enterprise and any subsequent reversals of such provisions;
  - c. Costs of litigation settlements;
  - d. Other reversals of provisions.
6. **Income tax expense.** The total of taxes payable and deferred taxation adjustments for the period covered by the income statement.
7. **Discontinued operations.** IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, was issued by the IASB as part of its convergence program with US GAAP.

IFRS 5 created a new "held for sale" category of asset into which assets, or "disposal groups" of assets, and liabilities that are to be sold, are classified. Such assets or groups of assets are to be valued at the lower of carrying value and fair value less selling costs. Any resulting write-down appears, net of tax, as part of the caption "discontinued operations" in the statement of income.

The other component of this line is the post-tax profit or loss of discontinued operations. A discontinued operation is defined as a component of an entity that either has been disposed of, or has been classified as held-for-sale. It must also:

- Be a separate major line of business or geographical area of operations;
- Be a part of a single coordinated plan for disposal; or
- Be a subsidiary acquired exclusively with a view to resale.

The two elements of the single line of statement of income have to be analysed in the notes, breaking down the related income tax expense between the two, as well as showing the components of revenue, expense and pre-tax profit of the discontinued items.

For the asset or disposal group to be classified as held-for-sale, and its related earnings to be classified as discontinued, IFRS 5 says that the sale must be highly probable, the asset must be saleable in its current condition, and the sale price must be reasonable in relation to its fair value. The appropriate level of management in the group must be committed to a plan to sell the asset and an active program has been embarked upon. Sale should be expected within one year of classification and the standard sets out stringent conditions for any extension of this, which are based on elements outside of the control of the entity.

Where an operation meets the criteria for classification as discontinued, but will be abandoned within one year rather than be sold, it should also be included in discontinued operations. Assets or disposal groups categorized as held-for-sale are not depreciated further.

**Example of disclosure of discontinued operations under IFRS 5**

	<u>20XX</u>	<u>20XX-1</u>
<b>Exemplum Reporting PLC</b>		
<b>Statement of Income</b>		
<b>For the Year Ended 31 December 20XX</b>		
<i>(in thousands of euros)</i>		
<b>Continuing Operations (Segments X &amp; Y):</b>		
Revenue	X	X
Operating expenses	(X)	(X)
Pre-tax profit from operating actives	X	X
Interest expense	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit after taxes	X	X
<b>Discontinuing operations (Segment Z):</b>		
Discontinued operations (note)	(X)	X
<b>Total enterprise:</b>		
Profit (loss) attributable to owners	X	X
<b>The relevant note is as follows:</b>		
<b>Discontinued Operations</b>		
Revenue	X	X
Operating expenses	(X)	(X)
Provision for end-of-service benefits	(X)	-
Interest expense	(X)	(X)
Pre-tax profit	X	X
Income tax	(X)	(X)
Discontinued earnings	X	X
Impairment loss	(X)	(X)
Income tax	X	X
Write-down of assets	(X)	(X)
Discontinued operations, net	(X)	(X)

### ***Aggregating items***

Aggregation of items should not serve to conceal significant information, as would the netting of revenues against expenses, or the combining of other elements that are individually of interest to readers, such as bad debts and depreciation. The categories “other” or “miscellaneous expense” should contain, at maximum, an immaterial total amount of aggregated, individually insignificant elements. Once this total approaches, for example, 10% of total expenses (or any other materiality threshold), some other aggregations, together with appropriate explanatory titles, should be selected.

Information is material if its omission or misstatement or non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item judged in the particular circumstances of its omission (according to IASB’s *Framework*). But it is often forgotten that materiality is also linked with understandability and the level of precision in which the financial statements are to be presented. For instance, the financial statements are often rendered more understandable by rounding information to the nearest thousand currency units (e.g., US dollars). This obviates the necessity of loading the financial statements with unnecessary detail. However, it should be borne in mind that the use of the level of precision that makes presentation possible in the nearest thousands of currency units is acceptable only as long as the threshold of materiality is not surpassed.

### ***Offsetting items of revenue and expense***

Materiality also plays a role in the matter of allowing or disallowing offsetting of the items of income and expense. IAS 1 addresses this issue and prescribes rules in this area. According to IAS 1, assets and liabilities or income and expenses may not be offset against each other, unless required or permitted by an IFRS. Usually, when more than one event occurs in a given reporting period, losses and gains on disposal of non-current assets or foreign exchange gains and losses are seen reported on a net basis, due to the fact that they are not material individually (compared to other items on the income statement). However, if they were material individually, they would need to be disclosed separately according to the requirements of IAS 1.

However, the reduction of accounts receivable by the allowance for doubtful accounts, or of property, plant and equipment by the accumulated depreciation, are acts that reduce these assets by the appropriate valuation accounts and are not considered to be offsetting assets and liabilities.

Views differ as to the treatment of disposal gains and losses arising from the routine replacement of non-current assets. Some experts believe that these should be separately disclosed as a disposal transaction, whereas others point out that if the depreciation schedule is estimated correctly, there should be no disposal gain or loss. Consequently, any difference between carrying value and disposal proceeds is akin to an adjustment to previous depreciation, and should logically flow through the income statement in the same caption where the depreciation was originally reported. Here again, the issue comes down to one of materiality: does it affect users’ ability to make economic decisions?

IAS 1 further clarifies that when items of income or expense are offset, the enterprise should nevertheless consider, based on materiality, the need to disclose the gross amounts in the notes to the financial statements. This standard gives the following examples of transactions that are incidental to the main revenue-generating activities of an enterprise and whose results when presented by offsetting or reporting on a net basis, such as netting any gains with related expenses, reflect the substance of the transaction:

1. Gains or losses on the disposal of non-current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amounts of the asset and related selling expenses;
2. Expenditure related to a provision that is reimbursed under a contractual arrangement with a third party may be netted against the related reimbursement.

## **OTHER COMPREHENSIVE INCOME**

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Under IAS 1, *other comprehensive income* (OCI) includes items of income and expense (including reclassification adjustments) that are not recognized in profit or loss as may be required or permitted by other IFRS. The components of OCI include (1) changes in revaluation surplus (IAS 16 and IAS 38); (2) actuarial gains and losses on defined benefit plans (IAS 19); (3) translation gains and losses of foreign operations (IAS 21); (4) gains and losses on remeasuring available-for-sale financial assets (IAS 39); and (5) the effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

The above items and an entity's share of other comprehensive income of any associate must be classified between those that:

1. Will not be reclassified subsequently to profit or loss; and
2. Will be reclassified subsequently to profit or loss.

The amount of income tax relating to each component of OCI, including reclassification adjustments, should be disclosed either on the face of the statement of comprehensive income or in the notes.

Components of OCI can be presented in one of two ways:

1. Net of related tax effects; or
2. Before related tax effects with one amount shown for the aggregate amount of income tax relating to those components.

Other IFRS specify whether and when amounts previously recognized in OCI are reclassified to profit or loss. The purpose of this requirement is to avoid double-counting of OCI items in total comprehensive income when those items are reclassified to profit or loss in accordance with other IFRS. Under IFRS, some items of OCI are subject to recycling while other items are not (under US GAAP, such items are always recycled). For example, gains realized on the disposal of a foreign operation are included in profit or loss of the current period. These amounts may have been recognized in OCI as unrealized foreign currency translation (CTA) gains in the current or previous periods. Those unrealized gains must be deducted from OCI in the period in which the realized gains are included in profit or loss to avoid double-counting them. In the same manner, for instance, unrealized gains or losses on available-for-sale (AFS) financial assets should not include realized gains or losses from the sale of AFS financial assets during the current period, which are reported in profit or loss. Reclassification adjustments arise, for example, on the following components:

- On disposal of a foreign operation (IAS 21);
- On derecognition of available-for-sale financial assets (IAS 39); and
- When a hedged forecast transaction affects profit or loss (IAS 39).

Reclassification adjustments *do not* arise on the following components, which are recognized in OCI, but are not reclassified to profit or loss in subsequent periods:

- On changes in revaluation surplus (IAS 16; IAS 38);
- On changes in actuarial gains or losses on defined benefit plans (IAS 19).

In accordance with IAS 16 and IAS 38, changes in revaluation surpluses may be transferred to retained earnings in subsequent periods when the asset is sold or when it is derecognized. Actuarial gains and losses are reported in retained earnings in the period that they are recognized as OCI (IAS 19).

### Reclassification Adjustments: An Example

In general, the reporting of unrealized gains and losses on available-for-sale (AFS) securities in comprehensive income is straightforward unless the company sells securities during the year. In such a case, double-counting results when a company reports realized gains and losses as part of profit or loss (net income), but also shows the amounts as part of other comprehensive income (OCI) in the current period or in previous periods.

When a sale of securities occurs, a reclassification adjustment is necessary to ensure that gains and losses are not double-counted. To illustrate, assume that Exemplum Reporting PLC has the following two AFS securities in its portfolio at the end of 20XX-1, its first year of operations:

<u>Investments</u>	<u>Cost</u>	<u>Fair value</u>	<u>Unrealized holding gain (loss)</u>
Radar Ltd	105,000	125,000	20,000
Konini Ltd	<u>260,000</u>	<u>300,000</u>	<u>40,000</u>
Total value of portfolio	265,000	425,000	60,000
Previous (accumulated) securities fair value adjustment balance			0
Securities fair value adjustment (Dr)			60,000

Exemplum Reporting PLC reports net income of 650,000 in 20XX-1 and presents a statement of profit or loss and other comprehensive income as follows:

**Exemplum Reporting PLC**  
**Statement of Profit or Loss and Other Comprehensive Income**  
**For the Year Ended 31 December 20XX-1**

Profit or loss	650,000
Other comprehensive income	
Holding gains on available-for-sale securities	60,000
Comprehensive income	710,000

During 20XX, Exemplum Reporting PLC sold 50% of the shares of the Konini Ltd common stock for 150,000 and realized a gain on the sale of 20,000 (150,000–130,000). At the end of 20XX, Exemplum Reporting PLC reports its AFS securities as follows:

<u>Investments</u>	<u>Cost</u>	<u>Fair value</u>	<u>Unrealized holding gain (loss)</u>
Radar Ltd	105,000	130,000	25,000
Konini Ltd	<u>130,000</u>	<u>160,000</u>	<u>30,000</u>
Total value of portfolio	235,000	290,000	55,000
Previous (accumulated) securities fair value adjustment balance			(60,000)
Securities fair value adjustment (Dr)			(5,000)



Exemplum Reporting PLC should report an unrealized holding loss of (5,000) in comprehensive income in 20XX and a realized gain of 20,000 on the sale of the Konini common stock. ABC reports net profit of 830,000 in 20XX and presents the components of holding gains (losses) as follows:

**Exemplum Reporting PLC**  
**Statement of Profit or Loss and Other Comprehensive Income**  
**For the Year Ended 31 December 20XX**

Net income (includes 20,000 realized gain on Konini shares)		830,000
Other comprehensive income		
Total holding gains	(5,000)	
Less: Reclassification adjustment for realized gains included in net income	(20,000)	(25,000)
Comprehensive income		805,000

In 20XX-1, Exemplum Reporting PLC included the unrealized gain on the Konini common stock in comprehensive income. In 20XX, Exemplum Reporting PLC sold the stock and reported the realized gain on sale in profit, which increased comprehensive income again. To prevent double-counting of this gain of 20,000 on the Konini shares, Exemplum Reporting PLC makes a reclassification adjustment to eliminate the realized gain from the computation of comprehensive income in 20XX.

An entity may display reclassification adjustments on the face of the financial statement in which it reports comprehensive income or disclose them in the notes to the financial statements. The IASB's view is that separate presentation of reclassification adjustments is essential to inform users clearly of those amounts that are included as income and expenses in two different periods—as income or expenses in other comprehensive income in previous periods and as income or expenses in profit or loss (net income) in the current period.

## STATEMENT OF CHANGES IN EQUITY

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Equity (owners', partners' or shareholders') represents the interest of the owners in the net assets of an entity and shows the cumulative net results of past transactions and other events affecting the entity since its inception. The statement of changes in equity reflects the increases and decreases in the net assets of an entity during the period. In accordance with IAS 1, all changes in equity from transactions with owners are to be presented separately from non-owner changes in equity.

IAS 1 requires an entity to present a statement of changes in equity including the following components on the face of the statement:

1. Total comprehensive income for the period, segregating amounts attributable to owners and to non-controlling interest;
2. The effects of retrospective application or retrospective restatement in accordance with IAS 8, separately for each component of equity;
3. Contributions from and distributions to owners; and
4. A reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change, for each component of equity.

The amount of dividends recognized as distributions to equity holders during the period, and the related amount per share should be presented either on the face of the statement of changes in equity or in the notes.

According to IAS 1, except for changes resulting from transactions with owners (such as equity contributions, reacquisitions of the entity's own equity instruments, dividends, and costs related to these transactions with owners), the change in equity during the period represents the total amount of income and expense (including gains and losses) arising from activities other than those with owners.

The following should be disclosed, either in the statement of financial position or the statement of changes in equity, or in the notes:

1. For each class of share capital:
  - Number of shares authorized;
  - Number of shares issued and fully paid, and issued but not fully paid;
  - Par value per share, or that the shares have no par value;
  - Recognition of the number of shares outstanding at the beginning and at the end of the periods;
  - Any rights, preferences and restrictions attached;
  - Shares in the entity held by the entity or its subsidiaries; and
  - Shares reserved for issue under options and contracts for the sale of shares, including terms and amounts.
2. A description of the nature and purpose of each reserve within equity.

## US GAAP COMPARISON

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US GAAP encourages but does not require comparative statements. The SEC requires income statements for three years.

SEC registrants are generally required to present expenses based on function, but there is no such requirement within US GAAP. The US GAAP income statement is presented in basically the same order as IFRS income statements, but differences in presentation and captions result in some differences. Previously, US GAAP included an income statement caption entitled, "Extraordinary Items" for items both infrequent and unusual. In 2015, the concept of extraordinary item was removed, making US GAAP more in line with IFRS, which does not allow for any extraordinary items. There are no GAAP requirements that address specific performance measures, such as operating profit. However, the SEC requires the presentation of certain headings and subtotals. Also, public companies cannot disclose non-GAAP measures in the financial statements or accompanying notes.

Discontinued operations under US GAAP are components held for sale or disposed of, for which there will be no significant continuing cash flows or involvement with the disposed component.

<b>Sources of IFRS</b> <i>IAS 7</i>
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## SCOPE

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The statement of cash flows is prepared in terms of IAS 7 and must be presented as an integral part of the financial statements in the form of a separate statement.

## DEFINITIONS OF TERMS

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**Cash.** Cash on hand and demand deposits with banks or other financial institutions.

**Cash equivalents.** Short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Treasury bills, commercial paper, and money market funds are all examples of cash equivalents.

**Direct method.** A method that derives the net cash provided by or used in operating activities from major components of operating cash receipts and payments.

**Financing activities.** The transactions and other events that cause changes in the size and composition of an entity's contributed equity and borrowings.

**Indirect (reconciliation) method.** A method that derives the net cash provided by or used in operating activities by adjusting profit (loss) for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

**Investing activities.** The acquisition and disposal of long-term assets and other investments not included in cash equivalents. An amendment effective for annual periods beginning on or after January 1, 2010, states explicitly that only expenditures that result in a recognized asset in the statement of financial position are eligible for classification as investing activities. Examples of expenditures that in certain instances do not result in the recognition of assets are exploration and evaluation activities; also expenditures on advertising and promotional activities, staff training, and research and development could raise such an issue.

**Operating activities.** The transactions and other events not classified as financing or investing activities. In general, operating activities are principal revenue-producing activities of an entity that enter into the determination of profit or loss, including the sale of goods and the rendering of services.

## BACKGROUND

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### Benefits of Statement of Cash Flows

The perceived benefits of presenting the statement of cash flows in conjunction with the statement of financial position and the statement of profit or loss and comprehensive income have been highlighted by IAS 7 to be as follows:

1. It provides an insight into the financial structure of the entity (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

The statement of cash flows discloses important information about the cash flows from operating, investing and financing activities, information that is not available or as clearly discernible in either the statement of financial position or the statement of profit or loss and comprehensive income. The additional disclosures which are either recommended by IAS 7 (such as those relating to undrawn borrowing facilities or cash flows that represent increases in operating capacity) or required to be disclosed by the standard (such as that about cash held by the entity but not available for use) provide a wealth of information for the informed user of financial statements. Taken together, the statement of cash flows coupled with these required or recommended disclosures provide the user with vastly more insight into the entity's performance and position, and its probable future results, than would the statement of financial position and statement of comprehensive income alone.

2. It provides additional information to the users of financial statements for evaluating changes in assets, liabilities, and equity of an entity.

When comparative statements of financial position are presented, users are given information about the entity's assets and liabilities at the end of each of the years. Were the statement of cash flows not presented as an integral part of the financial statements, it would be necessary for users of comparative financial statements either to speculate about how and why certain amounts reported in the statement of financial position changed from one period to another, or to compute (at least for the latest year presented) approximations of these items for themselves. At best, however, such a do-it-yourself approach would derive the net changes (the increase or decrease) in the individual assets and liabilities and attribute these to normally related accounts in the statement of comprehensive income. (For example, the net change in accounts receivable from the beginning to the end of the year would be used to convert reported sales to cash-basis sales or cash collected from customers.)

While basic changes in the statement of financial position can be used to infer cash flow implications, this is not universally the case. More complex combinations of events (such as the acquisition of another entity, along with its accounts receivables, which would be an increase in that asset which was not related to sales to customers by the reporting entity during the period) would not immediately be comprehensible and might lead to incorrect interpretations of the data unless an actual statement of cash flows were presented.

3. It enhances the comparability of reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

There was considerable debate even as early as the 1960s and 1970s over accounting standardization, which led to the emergence of cash flow accounting. The principal argument in support of cash flow accounting by its earliest proponents was that it avoids the difficult to understand and sometimes seemingly arbitrary allocations inherent in accrual accounting. For example, cash flows provided by or used in operating activities are derived, under the indirect method, by adjusting profit (or loss) for items such as depreciation and amortization, which might have been computed by different entities using different accounting methods. Thus, accounting standardization will be achieved by converting the accrual-basis profit or loss to cash-basis profit or loss, and the resultant figures will become comparable across entities.

4. It serves as an indicator of the amount, timing and certainty of future cash flows. Furthermore, if an entity has a system in place to project its future cash flows, the statement of cash flows could be used as a touchstone to evaluate the accuracy of past projections of those future cash flows. This benefit is elucidated by the standard as follows:
  - a. The statement of cash flows is useful in comparing past assessments of future cash flows against current year's cash flow information; and
  - b. It is of value in appraising the relationship between profitability and net cash flows, and in assessing the impact of changing prices.

### **Exclusion of Non-Cash Transactions**

The statement of cash flows, as its name implies, includes only actual inflows and outflows of cash and cash equivalents. Accordingly, it excludes all transactions that do not directly affect cash receipts and payments. However, IAS 7 does require that the effects of transactions not resulting in receipts or payments of cash be disclosed elsewhere in the financial statements. The reason for not including non-cash transactions in the statement of cash flows and placing them elsewhere in the financial statements (e.g., the notes) is that it preserves the statement's primary focus on cash flows from operating, investing, and financing activities. It is thus important that the users of financial statements fully appreciate what this financial statement does—and does not—attempt to portray.

### **Components of Cash and Cash Equivalents**

Cash and cash equivalents include unrestricted cash (meaning cash actually on hand, or bank balances whose immediate use is determined by the management), other demand deposits, and short-term investments whose maturities at the date of acquisition by the entity were three months or less. Equity investments do not qualify as cash equivalents unless they fit the definition above of short-term maturities of three months or less, which would rarely, if ever, be true. Preference shares carrying mandatory redemption features, if acquired within three months of their predetermined redemption date, would meet the criteria above since they are, in substance, cash equivalents. These are very infrequently encountered circumstances, however.

Bank borrowings are normally considered as financing activities. However, in some countries, bank overdrafts play an integral part in the entity's cash management, and as such, overdrafts are to be included as a component of cash equivalents if the following conditions are met:

1. The bank overdraft is repayable on demand; and
2. The bank balance often fluctuates from positive to negative (overdraft).

Statutory (or reserve) deposits by banks (i.e., those held with the central bank for regulatory compliance purposes) are often included in the same statement of financial position caption as cash. The financial statement treatment of these deposits is subject to some controversy in certain countries, which becomes fairly evident from scrutiny of published financial statements of banks, as these deposits are variously considered to be either a cash equivalent or an operating asset. If the latter, changes in amount would be presented in the operating activities section of the statement of cash flows, and the item could not then be combined with cash in the statement of financial position. Since the appendix to

IAS 7, which illustrates the application of the standard to statements of cash flows of financial institutions, does not include statutory deposits with the central bank as a cash equivalent, the authors have concluded that there is little logic to support the alternative presentation of this item as a cash equivalent. Given the fact that deposits with central banks are more or less permanent (and in fact would be more likely to increase over time than to be diminished, given a going concern assumption about the reporting financial institution) the presumption must be that these are not cash equivalents in normal practice.

## PRESENTATION

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### Classifications in the Statement of Cash Flows

The statement of cash flows prepared in accordance with IAS 7 requires classification into these three categories:

1. *Operating activities*, which can be presented under the (IFRS-preferred) direct or the indirect method, include all transactions that are not investing and financing activities. In general, cash flows arising from transactions and other events that enter into the determination of profit or loss are operating cash flows. Operating activities are principal revenue-producing activities of an entity and include delivering or producing goods for sale and providing services.
2. *Investing activities* include the acquisition and disposal of property, plant and equipment and other long-term assets and debt and equity instruments of other entities that are not considered cash equivalents or held for dealing or trading purposes. Investing activities include cash advances and collections on loans made to other parties (other than advances and loans of a financial institution).
3. *Financing activities* include obtaining resources from and returning resources to the owners. Also included is obtaining resources through borrowings (short-term or long-term) and repayments of the amounts borrowed.

The following are examples of the statement of cash flows classification under the provisions of IAS 7:

	<u>Operating</u>	<u>Investing</u>	<u>Financing</u>
Cash inflows	<ul style="list-style-type: none"> <li>• Receipts from sale of goods or rendering of services</li> <li>• Sale of loans, debt, or equity instruments carried in trading portfolio</li> <li>• Returns on loans (interest)</li> <li>• Returns on equity securities (dividends)</li> </ul>	<ul style="list-style-type: none"> <li>• Principal collections from loans and sales of other entities' debt instruments</li> <li>• Sale of equity instruments* of other entities and from returns of investment in those instruments</li> <li>• Sale of plant and equipment</li> </ul>	<ul style="list-style-type: none"> <li>• Proceeds from issuing share capital</li> <li>• Proceeds from issuing debt (short-term or long-term)</li> <li>• Not-for-profits' donor-restricted cash that is limited to long-term purposes</li> </ul>

Cash outflows	<ul style="list-style-type: none"> <li>• Payments to suppliers for goods and services</li> <li>• Payments to or on behalf of employees</li> <li>• Payments of taxes</li> <li>• Payments of interest</li> <li>• Purchase of loans, debt, or equity instruments carried in trading portfolio</li> </ul>	<ul style="list-style-type: none"> <li>• Loans made and acquisition of other entities' debt instruments</li> <li>• Purchase of equity instruments* of other entities</li> <li>• Purchase of plant and equipment</li> </ul>	<ul style="list-style-type: none"> <li>• Payment of dividends</li> <li>• Repurchase of company's shares</li> <li>• Repayment of debt principal, including capital lease obligations</li> </ul>
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\* Unless held for trading purposes or considered to be cash equivalents.

Non-cash investing and financing activities should, according to IAS 7, be disclosed in the notes to financial statements (“elsewhere” is how the standard actually identifies this), but apparently are not intended to be included in the statement of cash flows itself. Examples of significant non-cash financing and investing activities might include:

1. Acquiring an asset through a finance lease;
2. Conversion of debt to equity;
3. Exchange of non-cash assets or liabilities for other non-cash assets or liabilities;
4. Issuance of stock to acquire assets.

**Basic example of a classified statement of cash flows**

**Exemplum Reporting PLC  
Statement of Cash Flows  
For the Year Ended 31 December 20XX**

Cash flows from operating activities	
Cash receipts from customers	X
Cash paid to suppliers and employees	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from/(used in) operating activities	<u>X</u>
Cash flows from investing activities:	
Acquisition of subsidiaries, net of cash acquired	X
Purchase of property, plant and equipment	(X)
Proceeds from the sale of equipment	X
Interest received	X
Dividends received	X
Net cash from/(used in) investing activities	<u>X</u>
Cash flows from financing activities:	
Proceeds from the issue of share capital	X
Proceeds from long-term borrowings	X
Dividends paid	(X)
Net cash from/(used in) financing activities	<u>X</u>

Net increase in cash and cash equivalents	X
Cash and cash equivalents at beginning of period	<u>X</u>
Effects of foreign exchange rate changes on the balance of cash held in foreign currencies	<u>X</u>
Cash and cash equivalents at end of period	<u>X</u>
<b>Footnote Disclosure of Non-cash Investing and Financing Activities</b>	
<b>Note X: Supplemental Statement of Cash Flows Information</b>	
Significant non-cash investing and financing transactions:	
Conversion of bonds into ordinary shares	X
Property acquired under finance leases	<u>X</u>
	<u>X</u>

## Reporting Cash Flows from Operating Activities

### *Direct vs. indirect methods*

The operating activities section of the statement of cash flows can be presented under the direct or the indirect method. However, IFRS has expressed a preference for the direct method of presenting net cash from operating activities. For their part, most preparers of financial statements have chosen overwhelmingly to ignore the recommendation of the standard setter, preferring by a very large margin to use the indirect method in lieu of the recommended direct method.

The *direct method* shows the items that affected cash flow and the magnitude of those cash flows. Cash received from, and cash paid to, specific sources (such as customers and suppliers) are presented, as opposed to the indirect method's conversion of accrual-basis profit (or loss) to cash flow information by means of a series of add-backs and deductions. Entities using the direct method are required by IAS 7 to report the following major classes of gross cash receipts and gross cash payments:

1. Cash collected from customers.
2. Interest and dividends received.<sup>1</sup>
3. Cash paid to employees and other suppliers.
4. Interest paid.<sup>2</sup>
5. Income taxes paid.
6. Other operating cash receipts and payments.

Given the availability of alternative modes of presentation of interest and dividends received, and of interest paid, it is particularly critical that the policy adopted be followed consistently. Since the face of the statement of cash flows will in almost all cases make it clear what approach has been elected, it is not usually necessary to spell this out in the accounting policy note to the financial statements, although this certainly can be done if it would be useful to do so.

An important advantage of the direct method is that it permits the user to better comprehend the relationships between the entity's profit or loss and its cash flows. For example, payments of expenses are shown as cash disbursements and are deducted from cash receipts. In this way the user is able to recognize the cash receipts and cash payments for the

<sup>1</sup> Alternatively, interest and dividends received may be classified as investing cash flows rather than as operating cash flows because they are returns on investments.

<sup>2</sup> Alternatively, IAS 7 permits interest paid to be classified as a financing cash flow, because this is the cost of obtaining financing.



period. Formulas for conversion of various statement of profit or loss and comprehensive income amounts for the direct method presentation from the accrual basis to the cash basis are summarized below.

<u>Accrual basis</u>	<u>Additions</u>	<u>Deductions</u>	<u>Cash basis</u>
Net sales	+ Beginning AR	– Ending AR AR written off	= Cash received from customers
Cost of goods sold	+ Ending inventory Beginning AP	– Depreciation* and amortization* Beginning inventory Ending AP	= Cash paid to suppliers
Operating expenses	+ Ending prepaid expenses Beginning accrued expenses	– Depreciation and amortization Beginning prepaid expenses Ending accrued expenses payable Bad debts expense	= Cash paid for operating expenses

\* Applies to a manufacturing entity only

From the foregoing it can be appreciated that the amounts to be included in the operating section of the statement of cash flows, when the direct approach is utilized, are derived amounts that must be computed (although the computations are not onerous); they are not, generally, amounts that exist as account balances simply to be looked up and then placed in the statement. The extra effort needed to prepare the direct method operating cash flow data may be a contributing cause of why this method has been distinctly unpopular with preparers.

The *indirect method* (sometimes referred to as the reconciliation method) is the most widely used means of presentation of cash from operating activities, primarily because it is easier to prepare. It focuses on the differences between net operating results and cash flows. The indirect format begins with the amount of profit or loss for the year, which can be obtained directly from the statement of profit or loss and comprehensive income. Revenue and expense items not affecting cash are added or deducted to arrive at net cash provided by operating activities. For example, depreciation and amortization would be added back because these expenses reduce profit or loss without affecting cash.

The statement of cash flows prepared using the indirect method emphasizes changes in the components of most current asset and current liability accounts. Changes in inventory, accounts receivable, and other current accounts are used to determine the cash flow from operating activities. Although most of these adjustments are obvious (most preparers simply relate each current asset or current liability on the statement of financial position to a single caption in the statement of comprehensive income), some changes require more careful analysis. For example, it is important to compute cash collected from sales by relating sales revenue to both the change in accounts receivable and the change in the related bad debt allowance account.

As another example of possible complexity in computing the cash from operating activities, the change in short-term borrowings resulting from the purchase of equipment would not be included, since it is not related to operating activities. Instead, these short-term borrowings would be classified as a financing activity. Other adjustments under the indirect method include changes in the account balances of deferred income taxes, non-controlling interest, unrealized foreign currency gains or losses, and the profit or loss from investments under the equity method.

IAS 7 offers yet another alternative way of presenting the cash flows from operating activities. This could be referred to as the *modified indirect method*. Under this variant of the

indirect method, the starting point is not profit or loss but rather revenues and expenses as reported in the statement of comprehensive income. In essence, this approach is virtually the same as the regular indirect method, with two more details: revenues and expenses for the period.

The following summary, actually simply an expanded statement of financial position equation, may facilitate understanding of the adjustments to profit or loss necessary for converting accrual-basis profit or loss to cash-basis profit or loss when using the indirect method.

	<u>Current assets</u> *	–	<u>Fixed assets</u>	=	<u>Current liabilities</u>	+	<u>Long-term liabilities</u>	+	<u>Profit or loss</u>	<i>Accrual profit adjustment to convert to cash flow</i>
1.	Increase			=					Increase	Decrease
2.	Decrease			=					Decrease	Increase
3.				=	Increase				Decrease	Increase
4.				=	Decrease				Increase	Decrease

\*Other than cash and cash equivalents

For example, using row 1 in the above chart, a credit sale would increase accounts receivable and accrual-basis profit but would not affect cash. Therefore, its effect must be removed from the accrual profit to convert to cash profit. The last column indicates that the increase in a current asset balance must be deducted from profit to obtain cash flow.

Similarly, an increase in a current liability, row three, must be added to profit to obtain cash flows (e.g., accrued wages are in the statement of profit or loss and comprehensive income as an expense, but they do not require cash; the increase in wages payable must be added back to remove this non-cash flow expense from accrual-basis profit).

The major drawback to the indirect method involves the user's difficulty in comprehending the information presented. This method does not show from where the cash was received or to where the cash was paid. Only adjustments to accrual-basis profit or loss are shown. In some cases the adjustments can be confusing. For instance, the sale of equipment resulting in an accrual-basis loss would require that the loss be added to profit to arrive at net cash from operating activities. (The loss was deducted in the computation of profit or loss, but because the sale will be shown as an investing activity, the loss must be added back to profit or loss.)

Although the indirect method is more commonly used in practice, the IASB encourages entities to use the direct method. As pointed out by IAS 7, a distinct advantage of the direct method is that it provides information that may be useful in estimating or projecting future cash flows, a benefit that is clearly not achieved when the indirect method is utilized instead. Both the direct and indirect methods are presented below.

#### Direct method

Cash flows from operating activities:	
Cash received from sale of goods	X
Cash dividends received*	X
Cash provided by operating activities	X
Cash paid to suppliers	(X)

Cash paid for operating expenses	(X)
Cash paid for income taxes*	(X)
Cash disbursed for operating activities	(X)
<b>Net cash flows from operating activities</b>	<u><u>X</u></u>

\* Alternatively, could be classified as investing cash flow.

#### Indirect method

Cash flows from operating activities:	
Profit before income taxes	X
Adjustments for:	
Depreciation	X
Unrealized loss on foreign exchange	X
Interest expense	X
Operating profit before working capital changes	X
Increase in accounts receivable	(X)
Decrease in inventories	X
Increase in accounts payable	X
Cash generated from operations	X
Interest paid	(X)
Income taxes paid**	(X)
<b>Net cash flows from operating activities</b>	<u><u>X</u></u>

\*\* Taxes paid are usually classified as operating activities. However, when it is practical to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, then the tax cash flow is classified as an investing or financing activity as appropriate.

## OTHER REQUIREMENTS

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### *Gross vs. net basis*

The emphasis in the statement of cash flows is on gross cash receipts and cash payments. For instance, reporting the net change in bonds payable would obscure the financing activities of the entity by not disclosing separately cash inflows from issuing bonds and cash outflows from retiring bonds.

IAS 7 specifies two exceptions where netting of cash flows is allowed. Firstly, items with quick turnovers, large amounts and short maturities may be presented as net cash flows. Secondly, cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customers rather than those of the entity may also be reported on a net rather than a gross basis.

### *Foreign currency cash flows*

Foreign operations must prepare a separate statement of cash flows and translate the statement to the reporting currency using the exchange rate in effect at the time of the cash flow (a weighted-average exchange rate may be used if the result is substantially the same). This translated statement is then used in the preparation of the consolidated statement of cash flows. Non-cash exchange gains and losses recognized in the statement of profit or loss and other comprehensive income should be reported as a separate item when reconciling profit or loss and operating activities. For a more detailed discussion about the exchange rate effects on the statement of cash flows, see Chapter 23.

### ***Cash flow per share***

There is no requirement under IFRS to disclose such information in the financial statements of an entity, unlike the requirement to report earnings per share (EPS). In fact, cash flow per share is a somewhat disreputable concept, since it was sometimes touted in an earlier era as being indicative of an entity's "real" performance, when of course it is not a meaningful alternative to earnings per share because, for example, entities that are self-liquidating by selling productive assets can generate very positive total cash flows, and hence, cash flows per share, while decimating the potential for future earnings. Since, unlike a comprehensive statement of cash flows, cash flow per share cannot reveal the components of cash flow (operating, investing, and financing), its usage could be misleading.

While cash flow per share is not well regarded (it is specifically prohibited under US GAAP), it should be noted that in recent years a growing number of entities have resorted to displaying a wide range of pro forma amounts, some of which roughly correspond to cash-based measures of operating performance. These non-IFRS categories should be viewed with great caution, both because they convey the message that IFRS-based measures of performance are somehow less meaningful, and also because there are no standard definitions of the non-IFRS measures, opening the door to possible manipulation.

### **Net Reporting by Financial Institutions**

IAS 7 permits financial institutions to report cash flows arising from certain activities on a net basis. These activities, and the related conditions under which net reporting would be acceptable, are as follows:

1. Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customers rather than those of the bank, such as the acceptance and repayment of demand deposits;
2. Cash flows relating to deposits with fixed maturity dates;
3. Placements and withdrawals of deposits from other financial institutions; and
4. Cash advances and loans to banks' customers and repayments thereon.

### **Reporting Futures, Forward Contracts, Options and Swaps**

IAS 7 stipulates that cash payments for and cash receipts from futures contracts, forward contracts, option contracts and swap contracts are normally classified as investing activities, except:

1. When such contracts are held for dealing or trading purposes and thus represent operating activities; or
2. When the payments or receipts are considered by the entity as financing activities and are reported accordingly.

Further, when a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

### **Reporting Extraordinary Items in the Statement of Cash Flows**

IFRS has eliminated the categorization of gains or losses as being extraordinary in character, so this will no longer impact the presentation of the statement of cash flows under IFRS.

### Reconciliation of Cash and Cash Equivalents

An entity should disclose the components of cash and cash equivalents and should present a reconciliation of the difference, if any, between the amounts reported in the statement of cash flows and equivalent items reported in the statement of financial position.

### Acquisitions and Disposals of Subsidiaries and Other Business Units

IAS 7 requires that the aggregate cash flows from acquisitions and from disposals of subsidiaries or other business units should be presented separately as part of the investing activities section of the statement of cash flows. The following disclosures have also been prescribed by IAS 7 in respect to both acquisitions and disposals:

1. The total consideration paid or received;
2. The portion thereof discharged by cash and cash equivalents;
3. The amount of cash and cash equivalents in the subsidiary or business unit acquired or disposed of; and
4. The amount of assets and liabilities (other than cash and cash equivalents) acquired or disposed of, summarized by major category.

## DISCLOSURE AND EXAMPLES

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### Other Disclosures Required or Recommended by IAS 7

Certain additional information may be relevant to the users of financial statements in gaining an insight into the liquidity or solvency of an entity. With this objective in mind, IAS 7 sets forth other disclosures that are required or in some cases, recommended.

1. **Required disclosure**—The amount of significant cash and cash equivalent balances held by an entity that are not available for use by the group should be disclosed along with a commentary by management.
2. **Recommended disclosures**—The disclosures that are encouraged are the following:
  - a. The amount of undrawn borrowing facilities, indicating restrictions on their use, if any;
  - b. The aggregate amount of cash flows that are attributable to the increase in operating capacity separately from those cash flows that are required to maintain operating capacity; and
  - c. The amount of the cash flows arising from the operating, investing and financing activities of each reportable segment determined in accordance with IFRS 8. (See Chapter 8.)

The disclosures above recommended by IAS 7, although difficult to present, are useful in enabling the users of financial statements to better understand the entity's financial position.

**Basic example of preparation of the statement of cash flows under IAS 7 using a worksheet approach**

Using the following financial information for Exemplum Reporting PLC, preparation and presentation of the statement of cash flows according to the requirements of IAS 7 are illustrated. (Note that all figures in this example are in thousands of euros.)

**Exemplum Reporting PLC.  
Statements of Financial Position  
31 December 20XX and 20XX-1**

	<u>20XX</u>	<u>20XX-1</u>
<i>Assets</i>		
Cash and cash equivalents	3,000	1,000
Accounts receivable	5,000	2,500
Inventory	2,000	1,500
Prepaid expenses	1,000	1,500
Due from associates	19,000	19,000
	<b>20XX</b>	<b>20XX-1</b>
Property, plant and equipment, at cost	12,000	22,500
Accumulated depreciation	<u>(5,000)</u>	<u>(6,000)</u>
Property, plant and equipment, net	<u>7,000</u>	<u>16,500</u>
Total assets	<u>37,000</u>	<u>42,000</u>
<i>Liabilities</i>		
Accounts payable	5,000	12,500
Income taxes payable	2,000	1,000
Deferred taxes payable	<u>3,000</u>	<u>2,000</u>
Total liabilities	<u>10,000</u>	<u>15,500</u>
<i>Shareholders' equity</i>		
Share capital	6,500	6,500
Retained earnings	<u>20,500</u>	<u>20,000</u>
Total shareholders' equity	<u>27,000</u>	<u>26,500</u>
Total liabilities and shareholders' equity	<u>37,000</u>	<u>42,000</u>

**Exemplum Reporting PLC.  
Statement of Profit or Loss and Comprehensive Income  
For the Year Ended 31 December 20XX**

Sales	30,000
Cost of sales	(10,000)
Gross profit	20,000
Administrative and selling expenses	(2,000)
Interest expense	(2,000)
Depreciation of property, plant and equipment	(2,000)
Audit fees	(500)
Investment income	<u>3,000</u>
Profit before taxation	16,500
Taxes on income	<u>(4,000)</u>
Profit	<u>12,500</u>

The following additional information is relevant to the preparation of the statement of cash flows:

1. Equipment with a net book value of 7,500 and original cost of 10,500 was sold for 7,500.
2. All sales made by the company are credit sales.
3. The company received cash dividends (from investments) amounting to 3,000, recorded as income in the statement of comprehensive income for the year ended 31 December 20XX.
4. The company declared and paid dividends of 12,000 to its shareholders.
5. Interest expense for the year 20XX was 2,000, which was fully paid during the year. All administration and selling expenses incurred were paid during the year 20XX.
6. Income tax expense for the year 20XX was provided at 4,000, out of which the company paid 2,000 during 20XX as an estimate.

A worksheet can be prepared to ease the development of the statement of cash flows, as follows:

	<b>Cash Flow Worksheet</b>						
	<u>20XX</u>	<u>20XX-1</u>	<u>Change</u>	<u>Operating</u>	<u>Investing</u>	<u>Financing</u>	<u>Cash and equivalents</u>
Cash and equivalents	3,000	1,000	2,000				<u>2,000</u>
Accounts receivable	5,000	2,500	2,500	(2,500)			
Inventories	2,000	1,500	500	(500)			
Prepaid expenses	1,000	1,500	(500)	500			
Due from associates	19,000	19,000	0				
Property, plant and equipment	7,000	16,500	(9,500)	2,000	7,500		
Accounts payable	5,000	12,500	7,500	(7,500)			
Income taxes payable	2,000	1,000	1,000	1,000			
Deferred taxes payable	3,000	2,000	1,000	1,000			
Share capital	6,500	6,500	0				
Retained earnings	20,500	20,000	500	<u>9,500</u> <u>3,500</u>	<u>3,000</u> <u>10,500</u>	<u>(12,000)</u> <u>(12,000)</u>	<u>—</u> <u>2,000</u>

**Exemplum Reporting PLC.**  
**Statement of Cash Flows**  
**For the Year Ended 31 December 20XX**  
**(Direct method)**

<b><i>Cash flows from operating activities</i></b>		
Cash receipts from customers	27,500	
Cash paid to suppliers and employees	<u>(20,000)</u>	
Cash generated from operations	7,500	
Interest paid	<u>(2,000)</u>	
Income taxes paid	<u>(2,000)</u>	
Net cash flows from operating activities		3,500
<b><i>Cash flows from investing activities</i></b>		
Proceeds from the sale of equipment	7,500	
Dividends received	<u>3,000</u>	
Net cash flows from investing activities		10,500
<b><i>Cash flows from financing activities</i></b>		
Dividends paid	<u>(12,000)</u>	
Net cash flows used in financing activities		(12,000)
Net increase in cash and cash equivalents		2,000
Cash and cash equivalents, beginning of year		1,000
Cash and cash equivalents, end of year		<u>3,000</u>

Details of the computations of amounts shown in the statement of cash flows are as follows:

<b><i>Cash received from customers during the year</i></b>		
Credit sales	30,000	
Plus: Accounts receivable, beginning of year	2,500	
Less: Accounts receivable, end of year	<u>(5,000)</u>	
Cash received from customers during the year		<u>27,500</u>
<b><i>Cash paid to suppliers and employees</i></b>		
Cost of sales	10,000	
Less: Inventory, beginning of year	(1,500)	
Plus: Inventory, end of year	2,000	
Plus: Accounts payable, beginning of year	12,500	
Less: Accounts payable, end of year	(5,000)	
Plus: Administrative and selling expenses paid	<u>2,000</u>	
Cash paid to suppliers and employees during the year		<u>20,000</u>
Interest paid equals interest expense charged to profit or loss (per additional information)		<u>2,000</u>
<b><i>Income taxes paid during the year</i></b>		
Tax expense during the year (comprising current and deferred portions)	4,000	
Plus: Beginning income taxes payable	1,000	
Plus: Beginning deferred taxes payable	2,000	
Less: Ending income taxes payable	(2,000)	
Less: Ending deferred taxes payable	<u>(3,000)</u>	
Cash paid toward income taxes		<u>2,000</u>
Proceeds from sale of equipment (per additional information)		<u>7,500</u>
Dividends received during 2014 (per additional information)		<u>3,000</u>
Dividends paid during 2014 (per additional information)		<u>12,000</u>



**Exemplum Reporting PLC.**  
**Statement of Cash Flows**  
**For the Year Ended 31 December 20XX**  
**(Indirect method)**

<b><i>Cash flows from operating activities</i></b>		
Profit before taxation	16,500	
Adjustments for:		
Depreciation of property, plant and equipment	2,000	
Decrease in prepaid expenses	500	
Investment income	(3,000)	
Interest expense	<u>2,000</u>	
Increase in accounts receivable	(2,500)	
Increase in inventories	(500)	
Decrease in accounts payable	<u>(7,500)</u>	
Cash generated from operations	7,500	
Interest paid	(2,000)	
Income taxes paid	<u>(2,000)</u>	
Net cash from operating activities		<u>3,500</u>
<b><i>Cash flows from investing activities</i></b>		
Proceeds from sale of equipment	7,500	
Dividends received	<u>3,000</u>	
Net cash from investing activities		10,500
<b><i>Cash flows from financing activities</i></b>		
Dividends paid	<u>(12,000)</u>	
Net cash used in financing activities		<u>(12,000)</u>
Net increase in cash and cash equivalents		<u>2,000</u>
Cash and cash equivalents, beginning of year		<u>1,000</u>
Cash and cash equivalents, end of year		<u>3,000</u>

## CONSOLIDATED STATEMENT OF CASH FLOWS

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A consolidated statement of cash flows must be presented when a complete set of consolidated financial statements is issued. The consolidated statement of cash flows would be the last statement to be prepared, as the information to prepare it will come from the other consolidated statements (consolidated statement of financial position, statement of profit or loss and comprehensive income, and statement of changes in equity). The preparation of these other consolidated statements is discussed in Chapter 14.

The preparation of a consolidated statement of cash flows involves the same analysis and procedures as the statement for an individual entity, with a few additional items. The direct or indirect method of presentation may be used. When the indirect method is used, the additional non-cash transactions relating to the business combination, such as the differential amortization on group level, must also be reversed. Furthermore, all transfers to subsidiaries must be eliminated, as they do not represent a cash inflow or outflow of the consolidated entity.

All unrealized intragroup profits should have been eliminated in preparation of the other statements; thus, no additional entry of this sort should be required. Any profit allocated to non-controlling parties would need to be added back, as it would have been eliminated in computing consolidated profit but does not represent a true cash outflow. Finally, any dividend payments should be recorded as cash outflows in the financing activities section.

In preparing the operating activities section of the statement by the indirect method following a purchase business combination, the changes in assets and liabilities related to operations since acquisition should be derived by comparing the consolidated statement of financial position as of the date of acquisition with the year-end consolidated statement of financial position. These changes will be combined with those for the acquiring company up to the date of acquisition as adjustments to profit. The effects due to the acquisition of these assets and liabilities are reported under investing activities.

## **US GAAP COMPARISON**

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Under US GAAP, bank overdrafts are classified as financing activities.

Under US GAAP dividends received and interest paid and received are always included in operating cash flows. Dividends paid are always classified as financing activities.

Taxes paid are generally classified as operating cash flows, with specific rules for tax benefits associated with share-based compensation arrangements.

Under US GAAP, cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition.

Not all investments that qualify are required to be treated as cash equivalents. An entity shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition of cash equivalents are treated as cash equivalents.

If a derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument shall be considered cash flows from financing activities by the borrower.

by a promulgating authority, such as an accounting standard-setting body, and for other reasons. While there is no preventing these various factors from causing changes to occur, it is important that changes be made only when they result in improved financial reporting, or when necessitated by the imposition of new financial reporting requirements. Whatever the reason for introducing change, and hence the risk of non-comparability, to the financial reporting process, adequate disclosures must be made to achieve transparency in financial reporting so that users of the financial statements are able to comprehend the effects and compensate for them in performing financial analyses.

IAS 8 deals with accounting changes (i.e., changes in accounting estimates and changes in accounting policies) and also addresses the accounting for the correction of errors. A principal objective of IAS 8 is to prescribe accounting treatments and financial statement disclosures that will enhance comparability, both within an entity over a series of years, and with the financial statements of other entities.

Even though the correction of an error in financial statements issued previously is not considered an accounting change, it is discussed by IAS 8, and therefore is covered in this chapter.

In the preparation of financial statements there is an underlying presumption that an accounting policy, once adopted, should not be changed, but rather is to be uniformly applied in accounting for events and transactions of a similar type. This consistent application of accounting policies enhances the decision usefulness of the financial statements. The presumption that an entity should not change an accounting policy may be overcome only if the reporting entity justifies the use of an alternative acceptable accounting policy on the basis that it is preferable under the circumstances.

The IASB's *Improvements Project* resulted in significant changes being made to IAS 8. It now requires retrospective application of voluntary changes in accounting policies and retrospective restatement to correct prior period errors with the earliest reported retained earnings balance being adjusted for any effects of a correction of an error or of a voluntary change in accounting policy on earlier years. The only exception to this rule occurs when retrospective application or restatement would be impracticable to accomplish, and this has intentionally been made a difficult criterion to satisfy. The revised standard removed the allowed alternative in the previous version of IAS 8 (1) to include in profit or loss for the current period the adjustment resulting from changing an accounting policy or correcting a prior period error, and (2) to present unchanged comparative information from financial statements of prior periods.

The *Improvements Project* also resulted in some reorganization of materials in the standards, specifically relocating certain guidance between IAS 1 and IAS 8. As revised, certain presentational issues were moved to IAS 1, while guidance on accounting policies, previously found in IAS 1, was moved to IAS 8. In addition, included in revised IAS 8 is a newly established hierarchy of criteria to be applied in the selection of accounting policies.

As amended, IAS 8 incorporates the material formerly found in SIC 18, *Consistency—Alternative Methods*, which requires that an entity select and apply its accounting policies for a period consistently for similar transactions, other events and conditions, unless a standard or an interpretation specifically requires or permits categorization of items for which different policies may be appropriate, in which case an appropriate accounting policy shall be selected and applied consistently to each category. Simply stated, the expectation is that, in the absence of changes in promulgated standards, or changes in the character of the transactions being accounted for, the reporting entity should continue to use accounting

policies from one period to the next without change, and use them for all transactions and events within a given class or category without exception.

When IFRS are revised or new standards are developed, they are often promulgated a year or more prior to the date set for mandatory application. Disclosure of future changes in accounting policies must be made when the reporting entity has yet to implement a new standard that has been issued but that has not yet come into effect. In addition, disclosure is now required of the planned date of adoption, along with an estimate of the effect of the change on the entity's financial position, except if making such an estimate requires undue cost or effort.

Sources of IFRS <i>IAS 8</i>
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## SCOPE

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IAS 8 is applied in the selection of accounting policies and in accounting for changes in accounting policies, changes in estimates and corrections of prior year errors. This chapter addresses the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and corrections of errors in accordance with IAS 8.

## DEFINITIONS OF TERMS

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**Accounting policies.** Specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements. Management is required to adopt accounting policies that result in a fair, full and complete presentation of financial position, performance and cash flows of the reporting entity.

**Change in accounting estimate.** An adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the present status of, and expected future benefits and obligations associated with, that asset or liability. Prospective application applies to changes in estimates resulting from new information or new developments (which, therefore, are not corrections of errors). The use of reasonable estimates is an essential part of the financial statement preparation process and does not undermine their reliability.

**Change in accounting policy.** A change in accounting policy that either (1) is required by an IFRS or (2) is a change that results in the financial statements providing faithfully represented and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

**Impracticable.** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For management to assert that it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error, one or more of the following conditions must be present: (1) after making every reasonable effort the effect of the retrospective application or restatement is not determinable; (2) the retrospective application or restatement requires assumptions regarding what management's intent would have been in that period; or (3) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to develop objective information that would have been available at the time the original financial statements for the prior period (or periods) were authorized

for issue to provide evidence of circumstances that existed at that time regarding the amounts to be measured, recognized and/or disclosed by retrospective application.

**International Financial Reporting Standards (IFRS).** Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise International Financial Reporting Standards, International Accounting Standards (IAS), and Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

**Material.** Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances.

**Prior period errors.** Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that (1) was available when financial statements for those periods were authorized for issue, and (2) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting principles, oversight or misuse of available facts, use of unacceptable GAAP, and fraud.

**Prospective application.** The method of reporting a change in accounting policy and of recognizing the effect of a change in an accounting estimate, respectively, by (1) applying the new accounting policy to transactions, other events, and conditions occurring after the date as at which the policy is changed, and (2) recognizing and disclosing the effect of the change in the accounting estimate in the current and future periods affected by the change.

**Retrospective application.** Applying a new accounting policy to past transactions, other events and conditions as if that policy has always been applied.

**Retrospective restatement.** Correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

## IMPORTANCE OF COMPARABILITY AND CONSISTENCY IN FINANCIAL REPORTING

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Accounting principles—whether various IFRS or national GAAP—have long held that an important objective of financial reporting is to encourage comparability among financial statements produced by essentially similar entities. This is necessary to facilitate informed economic decision making by investors, creditors, regulatory agencies, vendors, customers, prospective employees, joint venturers and others. While full comparability will not be achieved as long as alternative principles of accounting and reporting for like transactions and events remain acceptable, a driving force in developing new accounting standards has been to enhance comparability. The IASB strives to remove alternatives within IFRS.

An important implication of comparability is that users be informed about the accounting policies that were employed in the preparation of the financial statements, any changes in those policies, and the effects of such changes. While historically some accountants opposed the focus on comparability, on the grounds that uniformity of accounting removes the element of judgement needed to produce the most faithful representation of an individual entity's financial position and performance, others have expressed concern that overemphasis on comparability might be an impediment to the development of

improved accounting methods. Increasingly, however, the paramount importance of comparability is being recognized, to which the ongoing convergence efforts strongly attest.

The *Conceptual Framework for Financial Reporting 2010* lists *comparability* as one of the enhancing qualitative characteristics of accounting information (also included as such characteristics are *verifiability*, *timeliness* and *understandability*) that are complementary to the fundamental qualitative characteristics: *relevance* and *faithful representation*. Comparability is explained as follows:

**Comparability** refers to the ability to identify similarities in, and differences among, items.

In addition, comparability should not be confused with uniformity; for information to be comparable, like things must look alike and different things must look different. The quality of consistency enhances the decision usefulness of financial statements to users by facilitating analysis and the understanding of comparative accounting data.

Strict adherence to IFRS or any other set of standards obviously helps in achieving comparability, since a common accounting language is employed by all reporting parties. According to IAS 1,

*The presentation and classification of items in the financial statements should be retained from one period to the next unless it is apparent that, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate with regard to the criteria for the selection and application of accounting policies in IAS 8; or an IFRS requires a change in presentation.*

It is, however, inappropriate for an entity to continue accounting for transactions in the same manner if the policies adopted lack qualitative characteristics of relevance and reliability. Thus, if more reliable and relevant accounting policy alternatives exist, it is better for the entity to change its methods of accounting for defined classes of transactions with, of course, adequate disclosure of both the nature of the change and of its effects.

## ACCOUNTING POLICY

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In accordance with IAS 1, the reporting entity's management is responsible for selecting and applying accounting policies that:

1. Present fairly financial position, results of operations, and cash flows of an entity, as required by IFRS;
2. Present information in a manner that provides relevant, reliable, comparable and understandable information;
3. Provide additional disclosures where necessary to enable users to understand the impact of particular transactions, other events, and conditions on the entity's financial position and performance.

Under IFRS management is required to disclose, in the notes to the financial statements, a description of all significant accounting policies of the reporting entity. In theory, if only one method of accounting for a type of transaction is acceptable, it is not necessary to explicitly cite it in the accounting policies note, although many entities do routinely identify all accounting policies affecting the major financial statement captions.

The "summary of significant accounting policies" is customarily, but not necessarily, the first note disclosure included in the financial statements.

## SELECTING ACCOUNTING POLICIES

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IAS 8 has established a hierarchy of accounting guidance for selecting accounting policies in accordance with IFRS. This is comparable to the “hierarchy of GAAP” established under US auditing standards many years ago (which was superseded by guidance in the FASB Accounting Standards Codification), and provides a logical ordering of authoritativeness for those instances when competing and possibly conflicting guidance exists. Given the relative paucity of authoritative guidance under IFRS (which is, of course, seen as a virtue by those who prefer “principles-based” standards, vis-à-vis the more “rules-based” standards arguably exemplified by US GAAP), heavy reliance is placed on reasoning by analogy from the existing standards and from materials found in various non-authoritative sources.

According to IAS 8, when selecting accounting policies with regard to an item in the financial statements, authoritative sources of such policies are included *only* in IFRS (they comprise International Financial Reporting Standards, International Accounting Standards (IAS) and Interpretations developed by the International Financial Reporting Standards Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC)). IFRS also provide guidance to assist management in applying their requirements. *Improvements to IFRS*, published in May 2008, clarified that only guidance that is an integral part of IFRS is mandatory. Guidance that is not an integral part of IFRS does not provide requirements for financial statements.

When there is *not* any IFRS standard or Interpretation that specifically applies to an item in the financial statements, transaction, other event or condition, management must use judgement in developing and applying an accounting policy. This should result in information that is both:

1. Relevant to the decision-making needs of users; and
2. Reliable in the sense that the resulting financial statements—
  - a. Will represent faithfully the financial position, performance and cash flows of the entity;
  - b. Will reflect the economic substance of transactions, other events, and conditions, and not merely their legal form;
  - c. Are neutral (i.e., free from bias);
  - d. Are prudent; and
  - e. Are complete in all material respects.

In making this judgement, management must give consideration to the following sources, listed in descending order of significance:

1. The requirements in IFRS and in Interpretations dealing with similar and related issues; and
2. The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the *Framework*.

Note that when developing a policy where IFRS does not provide guidance, IAS 8 also states that an entity may consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict

with the sources detailed in the preceding paragraph. In practice, this means that many IFRS reporters will look to US GAAP guidance where IFRS does not provide guidance.

## CHANGES IN ACCOUNTING POLICIES

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A change in an accounting policy means that a reporting entity has exchanged one accounting principle for another. According to IAS 8, the term *accounting policy* includes the accounting principles, bases, conventions, rules and practices used. For example, a change in inventory costing from “weighted-average” to “first-in, first-out” would be a change in accounting policy. Other examples of accounting policy options in IFRS include cost versus revaluation basis of accounting for property, plant and equipment and for intangible assets (IAS 16, IAS 38); cost versus fair value basis of accounting for investment property (IAS 40); and fair value versus proportionate share of the value of net assets acquired for valuing a non-controlling interest in business combinations (IFRS 3). Changes in accounting policy are permitted if:

1. The change is required by a standard or an interpretation; or
2. The change will result in a more relevant and reliable presentation of events or transactions in the financial statements of the entity.

IAS 8 does not regard the following as changes in accounting policies:

1. The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions; and
2. The adoption of a new accounting policy to account for events or transactions that did not occur previously or that were immaterial in prior periods.

The provisions of IAS 8 are not applicable to the initial adoption of a policy to carry assets at revalued amounts, although such adoption is indeed a change in accounting policy. Rather, this is to be dealt with as a revaluation in accordance with IAS 16 or IAS 38, as appropriate under the circumstances.

### *Applying changes in accounting policies*

Generally, IAS 8 provides that a change in an accounting policy should be reflected in financial statements by retrospective application to all prior periods presented as if that policy had always been applied, unless it is impracticable to do so. When a change in an accounting policy is made consequent to the enactment of a new IFRS, it is to be accounted for in accordance with the transitional provisions set forth in that standard.

An entity should account for a change in accounting policy as follows:

1. In general, initial application of an IFRS should be accounted for in accordance with the specific transitional provisions, if any, in that IFRS.
2. Initial application of an IFRS that does not include specific transitional provisions applying to that change should be applied *retrospectively*.
3. Voluntary changes in accounting policy should be applied *retrospectively*.

### *Retrospective application*

In accordance with IAS 8, retrospective application of a new accounting principle involves (1) adjusting the opening balance of each affected component of equity for the



earliest prior period presented, and (2) presenting other comparative amounts disclosed for each prior period as if the new accounting policy had always been applied.

Retrospective application to a prior period is required if it is practicable to determine the effect of the correction on the amounts in both the opening as well as closing statements of financial position for that period. Adjustments are made to the opening balance of each affected component of equity, usually to retained earnings.

In accordance with IAS 1 (Revised), whenever an entity applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements in accordance with IAS 8, a third statement of financial position is required to be presented as part of the minimum comparative information. The periods required to be presented upon are as at the end of the current period, the end of the preceding period and the beginning of the preceding period.

The date of that opening statement of financial position should be as at the beginning of the preceding period regardless of whether an entity's financial statements present comparative information for any additional periods presented voluntarily.

For example, assume that a change is adopted in 20XX and comparative 20XX-1 and 20XX-2 financial statements are to be presented with the 20XX financial statements. The change in accounting policy also affects previously reported financial positions and financial performance, but these are not to be presented in the current financial report. Therefore, since other components of equity are not affected, the cumulative adjustment (i.e., the cumulative amount of expense or income which would have been recognized in years prior to 20XX-2) as of the beginning of 20XX-2 is made to opening retained earnings in 20XX-2.

Retrospective application is accomplished by the following steps.

At the beginning of the preceding period presented in the financial statements,

- Step 1 - Adjust the carrying amounts of assets and liabilities for the cumulative effect of changing to the new accounting principle on periods prior to those presented in the financial statements.
- Step 2 - Offset the effect of the adjustment in Step 1 (if any) by adjusting the opening balance of each affected component of equity (usually opening balance of retained earnings).

For each individual prior period that is presented in the financial statements,

- Step 3 - Adjust the financial statements for the effects of applying the new accounting principle to that specific period.

<b>Example of retrospective application of a new accounting policy</b>
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Exemplum is a manufacturing business. During the 20XX financial year, the directors reviewed Exemplum's accounting policies and identified inventories as an area where it could change the current accounting policy with respect to inventory to better reflect the actual economic substance of its business.

The directors decide to change the valuation method used for raw material from the weighted-average cost method to the first-in, first-out (FIFO) method.

The value of the inventories is as follows:

	<i>Weighted-average</i>	<i>FIFO</i>
31 December 20XX-1	160,000	140,000
31 December 20XX	190,000	160,000

Exemplum was unable to obtain figures as at 1 January 20XX-1, for inventory in terms of FIFO as it was determined to be impracticable. Ignore any income tax effects.

The changes in the closing carrying amounts of inventories due to the change in the accounting policy are calculated as follows:

	<i>Weighted-average</i>	<i>FIFO</i>	<i>Decrease in values</i>
31 December 20XX-1	160,000	140,000	(20,000)
31 December 20XX	190,000	160,000	(30,000)

Due to the change in the accounting policy, the carrying values of inventories decreased at the beginning of the period by 20,000 and the end of the period by 30,000 (i.e., the period ended 31 December 20XX-1). The effect of this decrease is an increase in the cost of sales of 10,000 (30,000 – 20,000) for the period ended 31 December 20XX-2.

**Journals**

**31 December 20XX**

Cost of sales (P/L)	10,000	
Retained earnings—opening balance (Equity)	20,000	
Inventories (SFP)		30,000

*Accounting for the retrospective application of the new accounting policy.*

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*NOTE: Had the figures for January 20XX-1 been available, then the comparative statement of comprehensive income would also have been restated retrospectively for the change in accounting policy.*

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It is important to note that, in presenting the previously issued financial statements, the caption “as adjusted” is included in the column heading.

**Indirect effects.** Changing accounting policies sometimes results in indirect effects from legal or contractual obligations of the reporting entity, such as profit sharing or royalty arrangements that contain monetary formulas based on amounts in the financial statements. For example, if an entity had an incentive compensation plan that required it to contribute 15% of its pre-tax income to a pool to be distributed to its employees, the adoption of a new accounting policy could potentially require the entity to provide additional contributions to the pool computed.

Contracts and agreements are often silent regarding how such a change might affect amounts that were computed (and distributed) in prior years.

IAS 8 specifies that irrespective of whether the indirect effects arise from an explicit requirement in the agreement or are discretionary, if incurred they are to be recognized in the period in which the reporting entity makes the accounting change, which is 2012 in the example above.

### ***Impracticability exception***

Comparative information presented for a particular prior period need not be restated if doing so is *impracticable*. IAS 8 includes a definition of “impracticability” (see Definitions of Terms in this chapter) and guidance on its interpretation.

The standard states that applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. In order for management to assert that it is impracticable to retrospectively apply the new accounting principle, one or more of the following conditions must be present:

1. Management has made every reasonable effort to determine the retrospective adjustment and is unable to do so because the effects of retrospective application are not determinable (e.g., where the information is not available because it was not captured at the time).
2. If it were to apply the new accounting policy retrospectively, management would be required to make assumptions regarding its intent in a prior period that would not be able to be independently substantiated.
3. If it were to apply the new accounting policy retrospectively, management would be required to make significant estimates of amounts for which it is impossible to develop objective information that would have been available at the time the original financial statements for the prior period (or periods) were issued to provide evidence of circumstances that existed at that time regarding the amounts to be measured, recognized, and/or disclosed by retrospective application.

**Inability to determine period-specific effects.** If management is able to determine the adjustment to the opening balance of each affected component of equity as at the beginning of the earliest period for which retrospective application is practicable, but is unable to determine the period-specific effects of the change on all of the prior periods presented in the financial statements, IAS 8 requires the following steps to adopt the new accounting principle:

1. Adjust the carrying amounts of the assets and liabilities for the cumulative effect of applying the new accounting principle at the beginning of the earliest period presented for which it is practicable to make the computation, which may be the current period.
2. Any offsetting adjustment required by applying step 1 is made to each affected component of equity (usually to beginning retained earnings) of that period.

**Inability to determine effects on any prior periods.** If it is impracticable to determine the effects of adoption of the new accounting principle on any prior periods, the new principle is applied prospectively as of the earliest date that it is practicable to do so. One example could be when management of a reporting entity decides to change its inventory costing assumption from first-in, first-out (FIFO) to weighted-average (WA), as illustrated in the following example:

**Example of change from FIFO to the weighted-average method**

During 20XX Exemplum decided to change the inventory costing formula from FIFO to weighted-average (WA). The inventory values are as listed below using both FIFO and WA methods. Sales for the year were 15,000,000 and the company's total purchases were 11,000,000. Other expenses were 1,200,000 for the year. The company had 1,000,000 ordinary shares outstanding throughout the year.

**Inventory values**

	<u>FIFO</u>	<u>WA</u>	<u>Difference</u>
31 December 20XX-1 Base year	2,000,000	2,000,000	--
31 December 20XX	<u>4,000,000</u>	<u>1,800,000</u>	<u>2,200,000</u>
Variation.	<u>2,000,000</u>	<u>(200,000)</u>	<u>2,200,000</u>

The computations for 20XX-1 would be as follows:

	<u>FIFO</u>	<u>WA</u>	<u>Difference</u>
Sales	<u>15,000,000</u>	<u>15,000,000</u>	--
Cost of goods sold Beginning inventory	2,000,000	2,000,000	--
Purchases	<u>11,000,000</u>	<u>11,000,000</u>	--
Goods available for sale	13,000,000	13,000,000	--
Ending inventory	<u>4,000,000</u>	<u>1,800,000</u>	<u>2,200,000</u>
	<u>9,000,000</u>	<u>11,200,000</u>	<u>(2,200,000)</u>
Gross profit	6,000,000	3,800,000	2,200,000
Other expenses	<u>1,200,000</u>	<u>1,200,000</u>	--
Net income	<u>4,800,000</u>	<u>2,600,000</u>	<u>2,200,000</u>

The following is an example of the required disclosure in this circumstance.

**Note A: Change in Method of Accounting for Inventories**

During 20XX, management changed the company's method of accounting for all of its inventories from first-in, first-out (FIFO) to weighted-average (WA). The change was made because management believes that the WA method provides a better matching of costs and revenues. In addition, with the adoption of WA, the company's inventory pricing method is consistent with the method predominant in the industry. The change and its effect on net income (000 omitted except for per share amounts) and earnings per share for 20XX-1 are as follows:

	<u>Profit or loss</u>	<u>Earnings per share</u>
Profit or loss before the change	4,800	4.80
Reduction of net income due to the change	<u>2,200</u>	<u>2.20</u>
Profit or loss as adjusted	<u>2,600</u>	<u>2.60</u>

Management has not retrospectively applied this change to prior years' financial statements because beginning inventory on 1 January 20XX using WA is the same as the amount reported on a FIFO basis at 31 December 20XX-1. As a result of this change, the current period's financial statements are not comparable with those of any prior periods. The FIFO cost of inventories exceeds the carrying amount valued using WA by 2,200,000 at 31 December 20XX.

**Changes in amortization method**

Tangible or intangible long-lived assets are subject to depreciation or amortization, respectively, as set forth in IAS 16 and IAS 38. Changes in methods of amortization may be implemented in order to more appropriately recognize amortization or depreciation as an

asset's future economic benefits are consumed. For example, the straight-line method of amortization may be substituted for an accelerated method when it becomes clear that the straight-line method more accurately reports the consumption of the asset's utility to the reporting entity.

While a change in amortization method would appear to be a change in accounting policy and thus subject to the requirements of IAS 8 as revised, in fact special accounting for this change is mandated by IAS 16 and IAS 38.

Under IAS 16, which governs accounting for property, plant and equipment (long-lived tangible assets), a change in the depreciation method is a change in the technique used to apply the entity's accounting policy to recognize depreciation as an asset's future economic benefits are consumed. Therefore it is deemed to be a change in an accounting estimate, to be accounted for as described below. Similar guidance is found in IAS 38, pertaining to intangible assets. These standards are discussed in greater detail in Chapters 9 and 11.

The foregoing exception applies when a change is made to the method of amortizing or depreciating existing assets. A different result will be obtained when only newly acquired assets are to be affected by the new procedures.

When a company adopts a different method of amortization for newly acquired identifiable long-lived assets, and uses that method for all new assets of the same class without changing the method used previously for existing assets of the same class, this is to be accounted for as a change in accounting policy. No adjustment is required to comparative financial statements, nor is any cumulative adjustment to be made to retained earnings at the beginning of the current or any earlier period, since the change in principle is being applied prospectively only. In these cases, a description of the nature of the method changed and the effect on profit or loss and related per share amounts should be disclosed in the period of the change.

In the absence of any specific transitional provisions in a standard, a change in an accounting policy is to be applied retrospectively in accordance with the requirements set forth in IAS 8 for voluntary changes in accounting policy, as described below.

When applying the transitional provisions of a standard has an effect on the current period or any prior period presented, the reporting entity is required to disclose:

1. The fact that the change in accounting policy has been made in accordance with the transitional provisions of the standard, with a description of those provisions;
2. The amount of the adjustment for the current period and for each prior period presented (in accordance with IAS 1);
3. The amount of the adjustment relating to periods prior to those included in the comparative information; and
4. The fact that the comparative financial information has been restated, or that restatement for a particular prior period has not been made because it was impracticable.

If the application of the transitional provisions set forth in a standard may be expected to have an effect in future periods, the reporting entity is required to disclose the fact that the change in an accounting policy is made in accordance with the prescribed transitional provisions, with a description of those provisions affecting future periods.

Although the "impracticability" provision of revised IAS 8 may appear to suggest that restatement of prior periods' results could easily be avoided by preparers of financial statements, this is not an accurately drawn implication of these rules. The objective of IFRS in general, and of revised IAS 8 in particular, is to enhance the inter-period

comparability of information, since doing so will assist users in making economic decisions, particularly by allowing the assessment of trends in financial information for predictive purposes. There is accordingly a general presumption that the benefits derived from restating comparative information will exceed the resulting cost or effort of doing so—and that the reporting entity would make every reasonable effort to restate comparative amounts for each prior period presented.

In circumstances where restatement is deemed impracticable, the reporting entity will disclose the reason for not restating the comparative amounts.

In certain circumstances, a new standard may be promulgated with a delayed effective date. This is done, for example, when the new requirements are complex and IASB wishes to give adequate time for preparers and auditors to master the new materials. If, as of a financial reporting date, the reporting entity has not elected early adoption of the standard, it must disclose (1) the nature of the future change or changes in accounting policy; (2) the date by which adoption of the standard is required; (3) the date as at which it plans to adopt the standard; and (4) either (a) an estimate of the effect that the change(s) will have on its financial position, or (b) if such an estimate cannot be made without undue cost or effort, a statement to that effect. For an updated list of standards that are currently issued and not yet effective, you can refer to [www.wconsulting.co.za](http://www.wconsulting.co.za) where an updated list of standards issued and not yet effective is published.

## CHANGES IN ACCOUNTING ESTIMATES

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The preparation of financial statements requires frequent use of estimates—for such items as asset service lives, residual values, fair values of financial assets or financial liabilities, likely collectability of accounts receivable, inventory obsolescence, accrual of warranty costs, provision for pension costs and so on. These future conditions and events and their effects cannot be perceived with certainty; therefore, changes in estimates will be highly likely to occur as new information and more experience is obtained. IAS 8 requires that changes in estimates be *recognized prospectively* by “including it in profit or loss in:

1. The period of change if the change affects that period only; or
2. The period of change and future periods if the change affects both.”

For example, on January 1, 20XX, a machine purchased for 10,000 was originally estimated to have a 10-year useful life, and a salvage value of 1,000. On January 1, 20XX+5 (five years later), the asset is expected to last another 10 years and have a salvage value of 800. As a result, both the current period (the year ending December 31, 20XX+5) and subsequent periods are affected by the change. Annual depreciation expense over the estimated remaining useful life is computed as follows:

Original cost	€10,000
Less estimated salvage (residual) value	(1,000)
Depreciable amount	9,000
Accumulated depreciation, based original assumptions (10-year life)	
20XX	900
20XX+1	900
20XX+2	900

20XX+3	900
20XX+4	900
	4,500
Carrying value at 1/1/20XX+5	5,500
Revised estimate of salvage value	(800)
Depreciable amount	4,700
Remaining useful life at 1/1/20XX+5	10 years
	470 depreciation per year
Effect on 2016 net income	470–900 = 430 increase

The annual depreciation charge over the remaining life would be computed as follows:

$$\frac{\text{Book value of asset} - \text{Residual value}}{\text{Remaining useful life}} = \frac{€5,500 - €800}{10 \text{ years}} = 470/\text{yr.}$$

An impairment affecting the cost recovery of an asset should not be handled as a change in accounting estimate but instead should be treated as a loss of the period (see the discussion in Chapter 13).

In some situations it may be difficult to distinguish between changes in accounting policy and changes in accounting estimates. For example, a company may change from deferring and amortizing a cost to recording it as an expense as incurred because the future benefits of the cost have become doubtful. In this instance, the company is changing its accounting principle (from deferral to immediate recognition) because of its change in the estimate of the future utility of a particular cost incurred currently.

According to IAS 8, when it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

## CORRECTION OF ERRORS

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Although good internal control and the exercise of due care should serve to minimize the number of financial reporting errors that occur, these safeguards cannot be expected to completely eliminate errors in the financial statements. As a result, it was necessary for the accounting profession to promulgate standards that would ensure uniform treatment of accounting for error corrections.

IAS 8 deals with accounting for error corrections. Under earlier versions of this standard, so-called “fundamental errors” could be accounted for in accordance with either benchmark or allowed alternative approaches to effecting corrections. The IASB’s *Improvements Project* resulted in the elimination of the concept of fundamental error, and also the elimination of what had formerly been the allowed alternative treatment. Under revised IAS 8, therefore, the only permitted treatment is “retrospective restatement” as a prior period adjustment (subject to an exception when doing so is impracticable, as described below). Prior periods must be restated to report financial position and financial performance as they would have been reported had the error never arisen.

There is a clear distinction between errors and changes in accounting estimates. Estimates by their nature are approximations that may need revision as additional information becomes known. For example, when a gain or loss is ultimately recognized on the outcome of a contingency that previously could not be estimated reliably, this does not constitute the correction of an error and cannot be dealt with by restatement. However, if the

estimated amount of the contingency had been miscomputed from data available when the financial statements were prepared, at least some portion of the variance between the accrual and the ultimate outcome might reasonably be deemed an error. An error arises only where information available, which should have been taken into account, was ignored or misinterpreted.

Errors are defined by revised IAS 8 as omissions from and other misstatements of the entity's financial statements for one or more prior periods that are discovered in the current period and relate to reliable information that (1) was available when those prior period financial statements were prepared, and (2) could reasonably be expected to have been obtained and taken into account in the original preparation and presentation of those financial statements. Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and the effects of financial reporting fraud.

IAS 8 specifies that, when correcting an error in prior period financial statements, the term "restatement" is to be used. That term is exclusively reserved for this purpose so as to effectively communicate to users of the financial statements the reason for a particular change in previously issued financial statements.

An entity should correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by (1) "restating the comparative amounts for the prior periods presented in which the error occurred or (2) if the error occurred before the earliest prior period presented (beginning of the preceding period), restating the opening balances of assets, liabilities and equity for the earliest prior period presented."

Restatement consists of the following steps:

- Step 1 - Adjust the carrying amounts of assets and liabilities at the beginning of the first period presented (beginning of the preceding period) in the financial statements for the amount of the correction on periods prior to those presented in the financial statements.
- Step 2 - Offset the amount of the adjustment in Step 1 (if any) by adjusting the opening balance of retained earnings (or other components of equity or net assets, as applicable to the reporting entity) for that period.
- Step 3 - Adjust the financial statements of each individual prior period presented for the effects of correcting the error on that specific period (referred to as the period-specific effects of the error).

#### **Example of the correction of a material error**

Assume that Exemplum had overstated its depreciation expense by 50,000 in 20XX-2 and 40,000 in 20XX-1, both due to mathematical mistakes. The errors affected both the financial statements and the income tax returns in 20XX-2 and 20XX-1 and are discovered in 20XX. For this example, assume that only one comparative statement of financial position is given (note that the amendments to IAS 1 would require two comparative years to be given where there is a restatement as a result of an error).

Exemplum's statements of financial position and statements of comprehensive income and retained earnings as of and for the year ended 31 December 20XX-1, prior to the restatement were as follows:



**Exemplum**  
**Statement of Comprehensive Income and Retained Earnings**  
**Prior to Restatement**  
**Year Ended 31 December 20XX-1**

	<u>20XX-1</u>
Sales	<u>2,000,000</u>
Cost of sales	
Depreciation	750,000
Other	<u>390,000</u>
	<u>1,140,000</u>
Gross profit	860,000
Selling, general, and administrative expenses	<u>450,000</u>
Income from operations	410,000
Other income (expense)	<u>10,000</u>
Income before income taxes	420,000
Income taxes	<u>168,000</u>
Profit or loss	252,000
Retained earnings, beginning of year	6,463,000
Dividends	<u>(1,200,000)</u>
Retained earnings, end of year	<u>5,515,000</u>

**Exemplum**  
**Statement of Financial Position**  
**Prior to Restatement**  
**31 December 20XX-1**

	<u>20XX-1</u>
<b>Assets</b>	
Current assets	540,000
Property and equipment Cost	3,500,000
Accumulated depreciation and amortization	(430,000)
	<u>3,070,000</u>
Total assets	<u>5,610,000</u>
<b>Liabilities and stockholders' equity</b>	
Income taxes payable	–
Other current liabilities	<u>12,000</u>
Total current liabilities	<u>12,000</u>
Non-current liabilities	<u>70,000</u>
Total liabilities	<u>82,000</u>
Shareholders' equity	
Ordinary share	13,000
Retained earnings	<u>5,515,000</u>
Total shareholders' equity	<u>5,528,000</u>
Total liabilities and shareholders' equity	<u>5,610,000</u>

The following steps are followed to restate BC's prior period financial statements:

- Step 1 - Adjust the carrying amounts of assets and liabilities at the beginning of the first period presented (beginning of the preceding period) in the financial statements for the cumulative effect of correcting the error on periods prior to those presented in the financial statements.

The first period presented in the financial statements is 20XX-1. At the beginning of that year, 50,000 of the mistakes had been made and reflected on both the income tax return and financial statements. Assuming a flat 40% income tax rate and ignoring the effects of penalties and interest that would be assessed on the amended income tax returns, the following adjustment would be made to assets and liabilities at 1 January 20XX-1:

Decrease in accumulated depreciation	50,000
Increase in income taxes payable	<u>(20,000)</u>
	<u>30,000</u>

Step 2 - Offset the effect of the adjustment in Step 1 by adjusting the opening balance of retained earnings (or other components of equity or net assets, as applicable to the reporting entity) for that period.

Retained earnings at the beginning of 20XX-1 will increase by 30,000 as the offsetting entry resulting from Step 1.

Step 3 - Adjust the financial statements of each individual prior period presented for the effects of correcting the error on that specific period (referred to as the period-specific effects of the error).

The 20XX-1 prior period financial statements will be corrected for the period-specific effects of the restatement as follows:

Decrease in depreciation expense and accumulated depreciation	40,000
Increase in income tax expense and income taxes payable	<u>(16,000)</u>
Increase 20XX-2 profit or loss	<u>24,000</u>

The restated financial statements are presented below.

**Exemplum**  
**Statements of Comprehensive Income Retained Earnings**  
**As Restated Years Ended 31 December 20XX-1**

	<u>20XX-1</u> <u>Restated</u>
Sales	<u>2,000,000</u>
Cost of sales	
Depreciation	710,000
Other	<u>390,000</u>
	<u>1,100,000</u>
Gross profit	900,000
Selling, general, and administrative expenses	<u>450,000</u>
Income from operations	450,000
Other income (expense)	<u>10,000</u>
Income before income taxes	460,000
Income taxes	<u>184,000</u>
Profit or loss	<u>276,000</u>
Retained earnings, beginning of year, as originally reported	6,463,000
Restatement to reflect correction of depreciation (Note X)	30,000
Retained earnings, beginning of year, as restated	6,493,000
Dividends	<u>(1,200,000)</u>
Retained earnings, end of year	<u>5,569,000</u>

**Exemplum**  
**Statements of Comprehensive Income Retained Earnings**  
**As Restated Years Ended 31 December 20XX-1**

	<i>20XX-1</i>
	Restated
<b><i>Assets</i></b>	
Current assets	2,540,000
Property and equipment Cost	3,500,000
Accumulated depreciation and amortization	(340,000)
	3,160,000
Total assets	5,700,000
<b><i>Liabilities and shareholders' equity</i></b>	
Income taxes payable	36,000
Other current liabilities	12,000
Total current liabilities	48,000
Non-current liabilities	70,000
Total liabilities	118,000
<b><i>Shareholders' equity</i></b>	
Ordinary share	13,000
Retained earnings	5,569,000
Total shareholders' equity	5,582,000
Total liabilities and shareholders' equity	5,700,000

When restating previously issued financial statements, management is to disclose:

1. The fact that the financial statements have been restated;
2. The nature of the error;
3. The effect of the restatement on each line item in the financial statements;
4. The cumulative effect of the restatement on retained earnings (or other applicable components of equity or net assets).

These disclosures need not be repeated in subsequent periods.

The correction of an error in the financial statements of a prior period discovered subsequent to their issuance is reported as a prior period adjustment in the financial statements of the subsequent period. In some cases, however, this situation necessitates the recall or withdrawal of the previously issued financial statements and their revision and reissuance.

***Impracticability exception***

IAS 8 stipulates that the amount of the correction of an error is to be accounted for retrospectively. As with changes in accounting policies, comparative information presented for a particular period need not be restated, if restating the information is impracticable. As a result, when it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error, on all prior periods, the entity changes the comparative information as if the error had been corrected, prospectively from the earliest date practicable.

However, because the value ascribed to truly comparable data is high, this exception is not to be viewed as an invitation to not restate comparable periods' financial statements to remove the effects of most errors. The standard sets out what constitutes impracticability, as

discussed earlier in this chapter, and this should be strictly interpreted. When comparative information for a particular prior period is not restated, the opening balance of retained earnings for the next period must be restated for the amount of the correction before the beginning of that period.

In practice, the major criterion for determining whether or not to report the correction of the error is the materiality of the correction. There are many factors to be considered in determining the materiality of the error correction. Materiality should be considered for each correction individually as well as for all corrections in total. If the correction is determined to have a material effect on profit or loss, or the trend of earnings, it should be disclosed in accordance with the requirements set forth in the preceding paragraph.

The prior period adjustment should be presented in the financial statements as follows:

Retained earnings, 1 January 20XX-1, as reported previously	X
Correction of error (description) in prior period(s) (net of xx tax)	X
Adjusted balance of retained earnings at January 1, 2013	X
Profit or loss for the year	X
Retained earnings December 31, 20XX-1	X

In comparative statements, prior period adjustments should also be shown as adjustments to the beginning balances in the retained earnings statements. The amount of the adjustment on the earliest statement shall be the amount of the correction on periods prior to the earliest period presented. The later retained earnings statements presented should also show a prior period adjustment for the amount of the correction as of the beginning of the period being reported on.

Because it is to be handled retrospectively, the correction of an error—which by definition relates to one or more prior periods—is excluded from the determination of profit or loss for the period in which the error is discovered. The financial statements are presented as if the error had never occurred, by correcting the error in the comparative information for the prior period(s) in which the error occurred, unless impracticable. The amount of the correction relating to errors that occurred in periods prior to those presented in comparative information in the financial statements is adjusted against the opening balance of retained earnings of the earliest prior period presented. This treatment is entirely analogous to that now prescribed for changes in accounting policies.

When an accounting error is being corrected, the reporting entity is to disclose the following:

1. The nature of the error;
2. The amount of the correction for each prior period presented;
3. The amount of the correction relating to periods prior to those presented in comparative information; and
4. That comparative information has been restated, or that the restatement for a particular prior period has not been made because it would require undue cost or effort.

## US GAAP COMPARISON

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Under US GAAP, the Accounting Standards Codification (ASC) is the single source of authoritative literature.

There is no single standard that addresses accounting policies in US GAAP similar to IAS 8. However, similar to IFRS, accounting policies must be in accordance with existing GAAP and be applied consistently. Changes in accounting policy must be based on either a change required by an Accounting Standards Update, or a substantive argument that the new policy is superior to the current due to improved representational faithfulness.

Errors and changes in accounting policies are applied retrospectively for all the periods presented in a set of financial statements. The effect of errors and changes that occurred prior to the earliest period presented is included in the opening balances of equity for the earliest period presented. If it is impracticable to determine the financial effects of changes in accounting principles in prior periods, the effect is presented for the most recent period that is practicable. Reasons why it is impracticable are disclosed. Retrospective application of a new accounting policy, however, includes only direct effects and associated tax effects. Indirect effects (e.g., change in incentive pay accrual as a result of the application) are not included in prior periods, but in the current period, if and when those effects are realized.

Similar to IFRS, policies need not be applied to items that are immaterial. Materiality is defined in US GAAP very similarly to IFRS, which is the inclusion or omission of information from financial statements that would affect the decisions of users. The concept includes changes in the trend of earnings or other measures that otherwise would be considered material. The threshold for materiality for errors for interim financial statements is made on the relevant measure (i.e., income) for the year. However, errors that are material to the quarter must be disclosed.

One significant difference from IFRS is that the FASB Concepts Statements, the equivalent of the IFRS *Framework*, do not establish accounting standards or disclosure practices for particular items and are not US GAAP.

Under US GAAP, the accounting policies for subsidiaries do not need to be uniform.

1. The high volume of activity (or turnover) in the account;
2. The various cost flow alternatives that are acceptable; and
3. The classification of inventories.

There are two types of entities for which the accounting for inventories must be considered. The merchandising entity (generally, a retailer or wholesaler) has a single inventory account, usually entitled *merchandise inventory*. These are goods on hand that are purchased for resale. The other type of entity is the manufacturer, which generally has three types of inventories: (1) raw materials, (2) work in process, and (3) finished goods. *Raw materials inventory* represents goods purchased that will act as inputs in the production process leading to the finished product. *Work in process (WIP)* consists of the goods entered into production but not yet completed. *Finished goods inventory* is the completed product that is on hand awaiting sale.

In the case of either type of entity the same basic questions need to be resolved:

1. At what point in time should the items be included in inventory (ownership)?
2. What costs incurred should be included in the valuation of inventories?
3. What cost flow assumption should be used?
4. At what value should inventories be reported (net realizable value)?
5. What happens when inventories are purchased on deferred terms?
6. What are the disclosure requirements?

**Sources of IFRS**  
IAS 2, 8, 18, 34, 41

## DEFINITIONS OF TERMS

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**Absorption (full) costing.** Inclusion of all manufacturing costs (fixed and variable) in the cost of finished goods inventory.

**By-products.** Goods that result as an ancillary product from the production of a primary good; often having minor value when compared to the value of the principal product(s).

**Commodity broker-traders.** Those who buy or sell commodities for others or on their own account.

**Consignments.** Marketing method in which the consignor ships goods to the consignee, who acts as an agent for the consignor in selling the goods. The inventory remains the property of the consignor until sold by the consignee.

**Cost.** The sum of all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

**Direct (variable) costing.** Inclusion of only variable manufacturing costs in the cost of ending finished goods inventory. While often used for management (internal) reporting, this method is not deemed acceptable for financial reporting purposes.

**Finished goods.** Completed but unsold products produced by a manufacturing firm.

**First-in, first-out (FIFO).** Cost flow assumption; the first goods purchased or produced are assumed to be the first goods sold.

**Goods in transit.** Goods being shipped from seller to buyer at year-end.

**Inventory.** Assets held for sale in the normal course of business, or which are in the process of production for such sale, or are in the form of materials or supplies to be consumed in the production process or in the rendering of services.

**Joint products.** Two or more products produced jointly, where neither is viewed as being more important; in some cases additional production steps are applied to one or more joint products after a split-off point.

**Last-in, first-out (LIFO).** Cost flow assumption; the last goods purchased are assumed to be the first goods sold.

**Markdown.** Decrease below original retail price. A markdown cancellation is an increase (not above original retail price) in retail price after a markdown.

**Mark-up.** Increase above original purchase price. A mark-up cancellation is a decrease (not below original purchase price) in retail price after a mark-up.

**Net realizable value.** Estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

**Periodic inventory system.** Inventory system where quantities are determined only periodically by physical count.

**Perpetual inventory system.** Inventory system where up-to-date records of inventory quantities are kept.

**Raw materials.** For a manufacturing firm, materials on hand awaiting entry into the production process.

**Retail method.** Inventory costing method that uses a cost ratio to reduce ending inventory (valued at retail) to cost. Cost of inventory determined by reducing the sales value of inventories by the appropriate percentage gross margin.

**Specific identification.** Inventory system where the seller identifies which specific items have been sold and which ones remain in the closing inventories.

**Standard costs.** Predetermined unit costs, which are acceptable for financial reporting purposes if adjusted periodically to reflect current conditions.

**Weighted-average.** Periodic inventory costing method where ending inventory and cost of goods sold are priced at the weighted-average cost of all items available-for-sale.

**Work in process.** For a manufacturing firm, the inventories of partially completed products.

## RECOGNITION AND MEASUREMENT

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### Basic Concept of Inventory Costing

IFRS (IAS 2) establishes that the lower of cost and net realizable value should be the basis for the valuation of inventories. In contrast to IFRSs dealing with property, plant and equipment (IAS 16) or investment property (IAS 40), there is no option for revaluing inventories to current replacement cost or other measure of fair value, presumably due to the far shorter period of time over which such assets are held, thereby limiting the cumulative impact of inflation or other economic factors on reported amounts. However, note measurement exceptions in application of IAS 2 discussed above.

The cost of inventories of items that are ordinarily interchangeable, and goods or services produced and segregated for specific projects, are generally assigned carrying amounts by using the specific identification method. For most goods, however, specific identification is not a practical alternative. In cases where there are a large number of items of inventory and where the turnover is rapid, the standard prescribes two inventory costing formulas, namely the first-in, first-out (FIFO) and the weighted-average methods. A third alternative formerly endorsed by IFRS, the LIFO costing method, was designated as being unacceptable.

FIFO and weighted-average cost are the only acceptable cost flow assumptions under IFRS. Either method can be used to assign cost of inventories, but once selected an entity must apply that cost flow assumption consistently (unless the change to the other method can be justified under the criteria set forth by IAS 8). Furthermore, an entity is constrained from applying different cost formulas to inventories having similar nature and use to the entity. On the other hand, for inventories having different natures or uses, different cost formulas may be justified. Mere difference in location, however, cannot be used to justify applying different costing methods to otherwise similar inventories. Note that where a change in cost formula is made, this is likely to represent a change in accounting policy rather than a change in accounting estimate and will therefore need to be retrospectively applied under the requirements of IAS 8.

### Ownership of Goods

Inventory can only be an asset of the reporting entity if it is an economic resource of the entity at the date of the statement of financial position. In general, an entity should record purchases and sales of inventory when legal title passes. Although strict adherence to this rule may not appear to be important in daily transactions, proper inventory cut-off at the end of an accounting period is crucial for the correct determination of periodic results of operations. Thus, for accounting purposes, to obtain an accurate measurement of inventory quantity and corresponding monetary representation of inventory and cost of goods sold in the financial statements, it is necessary to determine when title passes.

The most common error made in this regard is to assume that title is synonymous with possession of goods on hand. This may be incorrect in two ways:

1. The goods on hand may not be owned; and
2. Goods that are not on hand may be owned.

There are four matters that may cause confusion about proper ownership:

1. Goods in transit;
2. Consignment sales;
3. Product financing arrangements; and
4. Sales made with the buyer having generous or unusual right of return.

### Goods in transit

At year-end, any *goods in transit* from seller to buyer may properly be includable in one, and only one, of those parties' inventories, based on the terms and conditions of the sale. Under traditional legal and accounting interpretation, goods are included in the inventory of the firm financially responsible for transportation costs. This responsibility may be indicated by shipping terms such as FOB, which is used in overland shipping contracts, and by FAS, CIF, C&F and ex-ship, which are used in maritime transport contracts.

The term *FOB* stands for "free on board." If goods are shipped *FOB destination*, transportation costs are paid by the seller and title does not generally pass until the carrier delivers the goods to the buyer; thus these goods are part of the seller's inventory while in transit. If goods are shipped *FOB shipping point*, transportation costs are paid by the buyer and title generally passes when the carrier takes possession; thus these goods are part of the buyer's inventory while in transit. The terms *FOB destination* and *FOB shipping point* often indicate a specific location at which title to the goods is transferred, such as FOB Milan. This means that the seller would most likely retain title and risk of loss until the goods are delivered to a common carrier in Milan who will act as an agent for the buyer.



A seller who ships *FAS* (free alongside) must bear all expense and risk involved in delivering the goods to the dock next to (alongside) the vessel on which they are to be shipped. The buyer bears the cost of loading and of shipment; thus title generally passes when the carrier takes possession of the goods.

In a *CIF* (cost, insurance and freight) contract, the buyer agrees to pay in a lump sum the cost of the goods, insurance costs, and freight charges. In a *C&F* contract, the buyer promises to pay a lump sum that includes the cost of the goods and all freight charges. In either case, the seller must deliver the goods to the carrier and pay the costs of loading; thus both title and risk of loss generally pass to the buyer upon delivery of the goods to the carrier.

A seller who delivers goods *ex-ship* normally bears all expense and risk until the goods are unloaded, at which time both title and risk of loss pass to the buyer.

The foregoing is meant only to define normal terms and usage and give an indication of the most likely point of transfer of risks and rewards; actual contractual arrangements between a given buyer and a given seller can vary widely and may point towards a different stage at which ownership passes. The accounting treatment should in all cases strive to mirror the substance of the legal terms established between the parties.

#### Examples of accounting for goods in transit

The Company J ships a truckload of merchandise on December 20XX to Customer K, which is located 2,000 miles away. The truckload of merchandise arrives at Customer K on January 20XX+1. Between December 20XX and January 20XX+1, the truckload of merchandise is goods in transit. The goods in transit requires special attention if the companies issue financial statements as of December 20XX. The reason is that the merchandise is the inventory of one of the two companies, but the merchandise is not physically present at either company. One of the two companies must include the cost of the goods in transit to the cost of the inventory that it has in its possession.

The terms of the sale will indicate which company should report the goods in transit as its inventory as of December 20XX. If the terms are *FOB shipping point*, and absent any other peculiar contractual conditions, the seller (Company J) will record a sale in 20XX and receivable, and will derecognize the goods in transit from its inventory. On December 20XX, Customer K is the owner of the goods in transit and will need to report a liability for the purchase, a payable, and must recognize the goods in transit to the cost of the inventory which is in its possession.

If the terms of the sale are *FOB destination*, and absent any other peculiar contractual conditions, Company J will not have a sale and receivable until January 20XX+1. This means Company J must continue to report the cost of the goods in transit in its inventory on December 20XX. (Customer K will not have a purchase, payable or inventory of these goods until January 20XX+1.) Vartan Gyroscope Company is located in Veracruz, Mexico, and obtains precision jeweled bearings from a supplier in Switzerland. The standard delivery terms are *free alongside (FAS)* a container ship in the harbour in Nice, France, so that Vartan takes legal title to the delivery once possession of the goods is taken by the carrier's dockside employees for the purpose of loading the goods on board the ship. When the supplier delivers goods with an invoiced value of 1,200,000 Mexican pesos to the wharf, it e-mails an advance shipping notice (ASN) and invoice to Vartan via an electronic data interchange (EDI) transaction, itemizing the contents of the delivery. Vartan's computer system receives the EDI transmission, notes the *FAS* terms in the supplier file, and therefore automatically logs it into the company computer system with the following entry:

Inventories	1,200,000	
Accounts payable		1,200,000

The goods are assigned an “In Transit” location code in Vartan’s perpetual inventory system. When the precision jeweled bearings delivery eventually arrives at Vartan’s receiving dock, the receiving staff records a change in inventory location code from “In Transit” to a code designating a physical location within the warehouse.

Vartan’s secondary precision jeweled bearings supplier is located in Vancouver, British Columbia, and ships overland using free on board (FOB) VeraCruz terms, so the supplier retains title until the shipment arrives at Vartan’s location. This supplier also issues an advance shipping notice by EDI to inform Vartan of the estimated arrival date, but in this case Vartan’s computer system notes the FOB VeraCruz terms, and makes no entry to record the transaction until the goods arrive at Vartan’s receiving dock.

### **Consignment sales**

There are specifically defined situations where the party holding the goods is doing so as an agent for the true owner. In *consignments*, the consignor (seller) ships goods to the consignee (buyer), which acts as the agent of the consignor in trying to sell the goods. In some consignments, the consignee receives a commission; in other arrangements, the consignee “purchases” the goods simultaneously with the sale of the goods to the final customer. Goods out on consignment are properly included in the inventory of the consignor and excluded from the inventory of the consignee. Disclosure may be required of the consignee, however, since common financial analytical inferences, such as days’ sales in inventory or inventory turnover, may appear distorted unless the financial statement users are informed. However, IFRS does not explicitly address this.

#### **Example of a consignment arrangement**

A company (Manufacturer) which produces Product A wants to attract a new customer B. Customer B is interested in Product A but doesn’t want to freeze (invest) cash in inventory and negotiates an inventory consignment arrangement with Manufacturer. Manufacturer will initially ship 100 tons of Product A to Customer B’s warehouse and will replenish this inventory as Customer B uses the product. Customer B will not take title to the product until the product is consumed by Customer B. The selling price for one ton of Product A is set at \$100. Manufacturer’s cost of one ton of Product A is \$60.

At the beginning of November 20XX, Manufacturer ships 100 tons of Product A to Customer B. The following journal entry is recorded by Manufacturer:

<b>Account Titles</b>	<b>Debit</b>	<b>Credit</b>
Inventory (Consignments)	\$6,000	
Finished Goods Inventory		\$6,000

The consignment inventory amount was determined as  $\$60 \times 100 \text{ tons} = \$6,000$ .

*Note: no journal entries are made by Customer B except for entering entries in an inventory system to track how much consigned inventory was received and consumed.*

During November 20XX, Customer B uses 70 tons of Product A and notifies Manufacturer about this consumption by sending an account statement. Manufacturer uses the account statement to issue an invoice to Customer B and record the sale of 70 tons along with the related cost of goods sold:

<u>Account Titles</u>	<u>Debit</u>	<u>Credit</u>
Accounts Receivable	\$7,000	
Sales		\$7,000

The sales amount was determined as \$100 x 70 tons = \$7,000.

<u>Account Titles</u>	<u>Debit</u>	<u>Credit</u>
Cost of Goods Sold	\$4,200	
Inventory (Consignments)		\$4,200

The cost of goods sold amount was determined as \$60 x 70 tons = \$4,200.

At the end of November 20XX or beginning of December 20XX, Manufacturer ships 70 tons of Product A to replenish the stock at Customer B's warehouse and makes the following journal entry:

<u>Account Titles</u>	<u>Debit</u>	<u>Credit</u>
Inventory (Consignments)	\$4,200	
Finished Goods Inventory		\$4,200

The Random Gadget Company ships a consignment of its wireless media control devices to a retail outlet of the Consumer Products Corporation. Random Gadget's cost of the consigned goods is €3,700, and it shifts the inventory cost into a separate inventory account to track the physical location of the goods. The entry is as follows:

Consignment out inventory	3,700	
Finished goods inventory		3,700

A third-party shipping company ships the cordless phone inventory from Random Gadget to Consumer Products. Upon receipt of an invoice for this €550 shipping expense, Random Gadget charges the cost to consignment inventory with the following entry:

Consignment out inventory	550	
Accounts payable		550

*To record the cost of shipping goods from the factory to Consumer Products Corporation.*

Consumer Products sells half the consigned inventory during the month for €2,750 in credit card payments, and earns a 22% commission on these sales, totalling €605. According to the consignment arrangement, Random Gadget must also reimburse Consumer Products for the 2% credit card processing fee, which is €55 (€2,750 × 2%). The results of this sale are summarized as follows:

Sales price to Consumer Product's customer earned on behalf of Random Gadget	€2,750
Less: Amounts due to Consumer Product in accordance with arrangement 22% sales commission	605
Reimbursement for credit card processing fee	<u>55</u>
Due to Random Gadget	<u>€2,090</u>

Upon receipt of the monthly sales report from Consumer Products, Random Gadget records the following entries:

Accounts receivable	2,090	
Cost of goods sold	55	
Commission expense	605	
Sales		2,750

*To record the sale made by Consumer Product acting as agent of Random Gadget, the commission earned by Consumer Product and the credit card fee reimbursement earned by Consumer Product in connection with the sale.*

Cost of goods sold	2,125	
Consignment out inventory		2,125

*To transfer the related inventory cost to cost of goods sold, including half the original inventory cost and half the cost of the shipment to Consumer Product [(€3,700 + €550 = €4,250) × ½ = €2,125].*

### **Right to return purchases**

A related inventory accounting issue that deserves special consideration arises in the situation that exists when the buyer is granted an exceptional right to return the merchandise acquired. This is not meant to address the normal sales terms found throughout commercial transactions (e.g., where the buyer can return goods, whether found to be defective or not, within a short time after delivery, such as five days). Rather, this connotes situations where the return privileges are well in excess of standard practice, so as to place doubt on the veracity of the purported sale transaction itself.

IAS 18 on 'Revenue' notes that when the buyer has the right to rescind the transaction under defined conditions and the seller cannot, with reasonable confidence, estimate the likelihood of this occurrence, the retention of significant risks of ownership makes this transaction not a sale. The sale is to be recorded only if the future amount of the returns can reasonably be estimated. If the ability to make a reasonable estimate is precluded, the sale is not to be recorded until further returns are unlikely. Although legal title has passed to the buyer, the seller must continue to include the goods in its measurement and valuation of inventory.

In some situations, a "side agreement" may grant the nominal customer greatly expanded or even unlimited return privileges, when the formal sales documents (bill of sale, bill of lading, etc.) make no such reference. These situations would be highly suggestive of financial reporting irregularities, in an apparent attempt to overstate revenues in the current period (and risk reporting high levels of sales returns in the following period, if customers do indeed avail themselves of the generous terms). In such circumstances, these sales should in all likelihood not be recognized, and the goods nominally sold should be returned to the reporting entity's inventories.

### **Accounting for Inventories**

The major objectives of accounting for inventories are the matching of appropriate costs against revenues in order to arrive at the proper determination of periodic income and the accurate representation of inventories on hand as assets of the reporting entity at the end of the reporting period.

The accounting for inventories is done under either a periodic or a perpetual system. In a *periodic inventory system*, the inventory quantity is determined periodically by a physical count. Next, a cost formula is applied to the quantity so determined to calculate the cost of ending inventory. Cost of goods sold is computed by adding beginning inventory and net purchases (or cost of goods manufactured) and subtracting ending inventory.

Alternatively, a *perpetual inventory system* keeps a running total of the quantity (and possibly the cost) of inventory on hand by recording all sales and purchases as they occur. When inventory is purchased, the inventory account (rather than purchases) is debited. When inventory is sold, the cost of goods sold and reduction of inventory are recorded. Periodic physical counts are necessary only to verify the perpetual records and to satisfy the tax regulations in some jurisdictions (tax regulations may require that a physical inventory count be undertaken at least annually).

### Valuation of Inventories

According to IAS 2, the primary basis of accounting for inventories is cost. *Cost* is defined as the sum of all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. This definition allows for significant interpretation of the costs to be included in inventory.

For raw materials and merchandise inventory that are purchased outright and not intended for further conversion, the identification of cost is relatively straightforward. The cost of these purchased inventories will include all expenditures incurred in bringing the goods to the point of sale and putting them in a saleable condition. These costs include the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from taxing authority, e.g., VAT, GST), transportation costs, insurance, and handling costs. Trade discounts, rebates, and other such items are to be deducted in determining inventory costs; failure to do so would result in carrying inventories at amounts in excess of true historical costs. Exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency are not permitted to be included in the costs of purchase of inventories.

The impact of interest costs as they relate to the valuation of inventories (IAS 23) is discussed in Chapter 10. IAS 23 requires capitalization of financing costs incurred during the manufacture, acquisition or construction of qualifying assets. However, borrowing costs will generally not be capitalized in connection with inventory acquisitions, since the period required to ready the goods for sale will generally not be significant. On the other hand, when a lengthy production process is required to prepare the goods for sale, the provisions of IAS 23 would be applicable and a portion of borrowing costs would become part of the cost of inventory. In practice, such situations are rare and IAS 23 allows an exemption for inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

*Conversion costs* for manufactured goods should include all costs that are directly associated with the units produced, such as labour and overhead. The allocation of overhead costs, however, must be systematic and rational, and in the case of fixed overhead costs (i.e., those which do not vary directly with level of production) the allocation process should be based on normal production levels. In periods of unusually low levels of production, a portion of fixed overhead costs must accordingly be charged directly to operations, and not taken into inventory.

Costs other than material and conversion costs are capitalized only to the extent they are necessary to bring the goods to their present condition and location. Examples might include

certain design costs and other types of preproduction expenditures if intended to benefit specific classes of customers. On the other hand, all research costs and most development costs (per IAS 38, as discussed in Chapter 11) would typically *not* become part of inventory costs. Also generally excluded from inventory would be such costs as administrative overheads (that do not contribute to bringing the inventories to their present location and condition), selling expenses, abnormal cost of wasted materials, labour, or other production expenditures; and storage costs (unless necessary in the production process) which must be treated as period costs. Included in overhead, and thus allocable to inventory, would be such categories as repairs, maintenance, utilities, rent, indirect labour, production supervisory wages, indirect materials and supplies, quality control and inspection, and the cost of small tools not capitalized.

**Example of recording raw material or component parts cost**

Accurate Laser-Guided Farm Implements, Inc. purchases lasers, a component that it uses in manufacturing its signature product. The company typically receives delivery of all its component parts and uses them in manufacturing its finished products during the fall and early winter, and then sells its stock of finished goods in the late winter and spring. The supplier invoice for a January delivery of lasers includes the following line items:

Lasers	€5,043
Shipping and handling	125
Shipping insurance	48
Sales tax	<u>193</u>
Total	<u>€5,409</u>

Since Accurate is using the lasers as components in a product that it resells, it will not pay the sales tax. However, both the shipping and handling charge and the shipping insurance are required for ongoing product acquisition, and so are included in the following entry to record receipt of the goods:

Inventory—components	5,216	
Accounts payable		5,216

*To record purchase of lasers and related costs (€5,043 + €125 + €48).*

On February 1, Accurate purchases a €5,000, two-month shipping insurance (known as “inland marine”) policy that applies to all incoming supplier deliveries for the remainder of the winter production season, allowing it to refuse shipping insurance charges on individual deliveries. Since the policy insures all inbound components deliveries (not just lasers) it is too time-consuming to charge the cost of this policy to individual components deliveries using specific identification, the controller can estimate a flat charge per delivery based on the number of expected deliveries during the two-month term of the insurance policy as follows:

€5,000 insurance premium ÷ 200 expected deliveries during the policy term = €25 per delivery and then charge each delivery with €25 as follows:

Inventory—components	25	
Prepaid insurance		25

*To allocate cost of inland marine coverage to inbound insured components shipments.*

In this case, however, the controller determined that shipments are expected to occur evenly during the two-month policy period and therefore will simply make a monthly standard journal entry as follows:

Inventory—components	2,500	
Prepaid insurance		2,500

*To amortize premium on inland marine policy using the straight-line method.*

Note that the controller must be careful, under either scenario, to ensure that perpetual inventory records appropriately track unit costs of components to include the cost of shipping insurance. Failure to do so would result in an understatement of the cost of raw materials inventory on hand at the end of any accounting period.

### ***Joint products and by-products***

In some production processes, more than one product is produced simultaneously. Typically, if each product has significant value, they are referred to as *joint products*; if only one has substantial value, the others are known as *by-products*. Under IAS 2, when the costs of each jointly produced good cannot be clearly determined, a rational allocation among them is required. Generally, such allocation is made by reference to the relative values of the jointly produced goods, as measured by ultimate selling prices. Often, after a period of joint production the goods are split off, separately incurring additional costs before being completed and ready for sale. The allocation of joint costs should take into account the additional individual product costs yet to be incurred after the point at which joint production ceases.

By-products by definition are products that have limited value when measured with reference to the primary good being produced. IAS 2 suggests that by-products be valued at net realizable value, with the costs allocated to by-products thereby being deducted from the cost pool which is allocated to the sole or several principal products.

For example, products A and B have the same processes performed on them up to the split-off point. The total cost incurred to this point is €80,000. This cost can be assigned to products A and B using their relative sales value at the split-off point. If A could be sold for €60,000 and B for €40,000, the total sales value is €100,000. The cost would be assigned on the basis of each product's relative sales value. Thus, A would be assigned a cost of €48,000 ( $60,000/100,000 \times 80,000$ ) and B a cost of €32,000 ( $40,000/100,000 \times 80,000$ ).

If inventory is exchanged with another entity for similar goods, the earnings process is generally not culminated. Accordingly, the acquired items are recorded at the recorded, or book, value of the items given up. In terms of IAS 18, such an exchange is not normally deemed to be a revenue-generating transaction and, as such, the transaction is accounted for as a straight exchange, unless it can be argued that the transaction undertaken lacks commercial substance.

In some jurisdictions, the categories of costs that are includable in inventories for tax purposes may differ from those that are permitted for financial reporting purposes under IFRS. To the extent that differential tax and financial reporting is possible (i.e., that there is no statutory requirement that the taxation rules constrain financial reporting) this situation will result in deferred taxation. This is discussed more fully in Chapter 26.

### ***Direct costing***

The generally accepted method of allocating fixed overhead to both ending inventories and cost of goods sold is commonly known as (*full*) *absorption costing*. IAS 2 requires that

absorption costing be employed. However, often for managerial decision-making purposes an alternative to absorption costing, known as *variable or direct costing*, is utilized. Direct costing requires classifying only direct materials, direct labour, and variable overhead related to production as inventory costs. All fixed costs are accounted for as period costs. The virtue of direct costing is that under this accounting strategy there will be a predictable, linear effect on marginal contribution from each unit of sales revenue, which can be useful in planning and controlling the business operation. However, such a costing method does not result in inventory that includes all costs of production, and therefore this is deemed not to be in accordance with IAS 2. If an entity uses direct costing for internal budgeting or other purposes, adjustments must be made to develop alternative information for financial reporting purposes.

### ***Differences in inventory costing between IFRS and tax requirements***

In certain tax jurisdictions, there may be requirements to include or exclude certain overhead cost elements which are handled differently under IFRS for financial reporting purposes. For example, in the US the tax code requires elements of overhead to be allocated to inventories, while IFRS demands that these be expensed as period costs. Another common area of difference in the US is the permission of LIFO as a basis of inventory valuation for tax purposes which as discussed above is not permitted under IFRS. Since tax laws do not dictate IFRS, the appropriate response to such a circumstance is to treat these as temporary differences, which will create the need for interperiod income tax allocation under IAS 12. Deferred tax accounting is fully discussed in Chapter 26.

## **METHODS OF INVENTORY COSTING UNDER IAS 2**

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### **Specific Identification**

The theoretical basis for valuing inventories and cost of goods sold requires assigning the production and/or acquisition costs to the specific goods to which they relate. For example, the cost of ending inventory for an entity in its first year, during which it produced ten items (e.g., exclusive single family homes), might be the actual production cost of the first, sixth, and eighth unit produced if those are the actual units still on hand at the date of the statement of financial position. The costs of the other homes would be included in that year's profit or loss as cost of goods sold. This method of inventory valuation is usually referred to as *specific identification*.

Specific identification is generally not a practical technique, as the product will generally lose its separate identity as it passes through the production and sales process. Exceptions to this would generally be limited to those situations where there are small inventory quantities, typically having high unit value and a low turnover rate. Under IAS 2, specific identification must be employed to cost inventories that are not ordinarily interchangeable, and goods and services produced and segregated for specific projects. For inventories meeting either of these criteria, the specific identification method is mandatory and alternative methods cannot be used.

Because of the limited applicability of specific identification, it is more likely to be the case that certain assumptions regarding the cost flows associated with inventory will need to be made. One of accounting's peculiarities is that these cost flows may or may not reflect the physical flow of inventory. Over the years, much attention has been given to both the flow of physical goods and the assumed flow of costs associated with those goods. In most jurisdictions, it has long been recognized that the flow of costs need not mirror the actual



flow of the goods with which those costs are associated. For example, a key provision in an early US accounting standard stated that:

*. . . cost for inventory purposes shall be determined under any one of several assumptions as to the flow of cost factors; the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.*

Under the current IAS 2, there are two acceptable cost flow assumptions. These are: (1) first-in, first-out (FIFO) method, and (2) the weighted-average method. There are variations of each of these cost flow assumptions that are sometimes used in practice, but if an entity presents its financial statements under IFRS it has to be careful not to apply a variant of these cost flow assumptions that would represent a deviation from the requirements of IAS 2. Furthermore, in certain jurisdictions, other costing methods, such as the last-in, first-out (LIFO) method and the base stock method, continue to be permitted. The LIFO method was an allowed alternative method of costing inventories under IAS 2 until the revision that became effective in 2005, at which time it was prohibited.

### First-In, First-Out (FIFO)

The FIFO method of inventory valuation assumes that the first goods purchased will be the first goods to be used or sold, regardless of the actual physical flow. This method is thought to parallel most closely the physical flow of the units for most industries having moderate to rapid turnover of goods. The strength of this cost flow assumption lies in the inventory amount reported in the statement of financial position. Because the earliest goods purchased are the first ones removed from the inventory account, the remaining balance is composed of items acquired closer to period end, at more recent costs. This yields results similar to those obtained under current cost accounting in the statement of financial position, and helps in achieving the goal of reporting assets at amounts approximating current values.

However, the FIFO method does not necessarily reflect the most accurate or decision-relevant income figure when viewed from the perspective of underlying economic performance, as older historical costs are being matched against current revenues. Depending on the rate of inventory turnover and the speed with which general and specific prices are changing, this mismatching could potentially have a material distorting effect on reported income. At the extreme, if reported earnings are fully distributed to owners as dividends, the entity could be left without sufficient resources to replenish its inventory stocks due to the impact of changing prices. (This problem is not limited to inventory costing; depreciation based on old costs of plant assets also may understate the true economic cost of capital asset consumption, and serve to support dividend distributions that leave the entity unable to replace plant assets at current prices.)

The following example illustrates the basic principles involved in the application of FIFO:

	<u>Units available</u>	<u>Units sold</u>	<u>Actual unit cost</u>	<u>Actual total cost</u>
Beginning inventory	100	--	€ 2.10	€ 210
Sale	--	75	--	--
Purchase	150	--	2.80	420
Sale	--	100	--	--
Purchase	<u>50</u>	--	3.00	<u>150</u>
Total	<u>300</u>	<u>175</u>		<u>€780</u>

Given these data, the cost of goods sold and the ending inventory balance are determined as follows:

	<u>Units</u>	<u>Unit cost</u>	<u>Total cost</u>
Cost of goods sold	100	€2.10	€ 210
	<u>75</u>	2.80	<u>210</u>
	<u>175</u>		<u>€ 420</u>
Ending inventory	50	3.00	€ 150
	<u>75</u>	2.80	<u>210</u>
	<u>125</u>		<u>€ 360</u>

Notice that the total of the units in cost of goods sold and ending inventory, as well as the sum of their total costs, is equal to the goods available-for-sale and their respective total costs.

The unique characteristic of the FIFO method is that it provides the same results under either the periodic or perpetual system. This will not be the case for any other costing method.

### Weighted-Average Cost

The other acceptable method of inventory valuation under revised IAS 2 involves averaging and is commonly referred to as the weighted-average cost method. The cost of goods available-for-sale (beginning inventory and net purchases) is divided by the units available-for-sale to obtain a weighted-average unit cost. Ending inventory and cost of goods sold are then priced at this average cost. For example, assume the following data:

	<u>Units available</u>	<u>Units sold</u>	<u>Actual unit cost</u>	<u>Actual total cost</u>
<u>Beginning inventory</u>	<u>100</u>	--	€ 2.10	€ 210
<u>Sale</u>	--	<u>75</u>	--	--
<u>Purchase</u>	150	--	2.80	420
<u>Sale</u>	--	100	--	--
<u>Purchase</u>	<u>50</u>	--	3.00	<u>150</u>
<u>Total</u>	<u>300</u>	<u>175</u>		<u>€ 780</u>

The weighted-average cost is €780/300, or €2.60. Ending inventory is 125 units at €2.60, or €325; cost of goods sold is 175 units at €2.60, or €455.

When the weighted-average assumption is applied to a perpetual inventory system, the average cost is recomputed after each purchase. This process is referred to as a moving average. Sales are costed at the most recent average. This combination is called the moving-average method and is applied below to the same data used in the weighted-average example above.

	<u>Units on hand</u>	<u>Purchases in euro</u>	<u>Sales in euro</u>	<u>Total cost</u>	<u>Inventory unit cost</u>
Beginning inventory	100	€ --	€ --	€ 210.00	€ 2.10
Sale (75 units @ €2.10)	25	--	157.50	52.50	2.10
Purchase (150 units, € 420)	175	420.00	--	472.50	2.70
Sale (100 units @ € 2.70)	75	--	270.00	202.50	2.70
Purchase (50 units, € 150)	125	150.00	--	352.50	2.82

Cost of goods sold is 75 units at €2.10 and 100 units at €2.70, or a total of €427.50.

## Net Realizable Value

As stated in IAS 2

*Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.*

The utility of an item of inventory is limited to the amount to be realized from its ultimate sale; where the item's recorded cost exceeds this amount, IFRS requires that a loss be recognized for the difference. The logic for this requirement is twofold: first, assets (in particular, current assets such as inventory) should not be reported at amounts that exceed net realizable value; and second, any decline in value in a period should be reported in that period's results of operations in order to achieve proper matching with current period's revenues. Were the inventory to be carried forward at an amount in excess of net realizable value, the loss would be recognized on the ultimate sale in a subsequent period. This would mean that a loss incurred in one period, when the value decline occurred, would have been deferred to a different period, which would clearly be inconsistent with several key accounting concepts.

IAS 2 states that estimates of net realizable value should be applied on an item-by-item basis in most instances, although it makes an exception for those situations where there are groups of related products or similar items that can be properly valued in the aggregate. As a general principle, item-by-item comparisons of cost to net realizable value are required, lest unrealized "gains" on some items (i.e., where the net realizable values exceed historical costs) offset the unrealized losses on other items, thereby reducing the net loss to be recognized. Since recognition of unrealized gains in profit or loss is generally proscribed under IFRS, evaluation of inventory declines on a grouped basis would be an indirect or "backdoor" mechanism to recognize gains that should not be given such recognition. Accordingly, the basic requirement is to apply the tests on an individual item basis.

### *Recoveries of previously recognized losses*

IAS 2 stipulates that a new assessment of net realizable value should be made in each subsequent period; when the reason for a previous write-down no longer exists (i.e., when net realizable value has improved), it should be reversed. Since the write-down was taken into income, the reversal should also be reflected in profit or loss. As under prior rules, the amount to be restored to the carrying value will be limited to the amount of the previous impairment recognized.

It should be noted that net realizable value is not the same as fair value. Net realizable value is the net amount an entity expects to receive from the sale of inventories and is therefore an entity specific measure. Fair value is a wider market based valuation that is defined in more detail under IFRS 13.

## Other Valuation Methods

Techniques for measurement of cost of inventories, such as the retail method or the standard cost method, may be used for convenience if the results approximate cost and where the application of the methods above is not practical.

### *Retail method*

IAS 2 recognizes that the retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impractical to use other costing methods.

The cost of inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

### **Standard costs**

Standard costs are predetermined unit costs used by many manufacturing firms for planning and control purposes. Standard costing is often useful for management (internal) reporting under some conditions. The use of standard costs in financial reporting is acceptable if adjustments are made periodically to reflect current conditions and if its use approximates one of the recognized cost flow assumptions. If appropriate, standard costs are incorporated into the accounts, and materials, work in process, and finished goods inventories are all carried on this basis of accounting.

**Inventories valued at fair value less costs to sell.** In case of commodity broker-traders' inventories, IAS 2 permits that these inventories can be valued at fair value less costs to sell. While allowing this exceptional treatment for inventories of commodity broker-traders, IAS 2 makes it mandatory that in such cases the fair value changes should be reported in profit and loss account for the period of change.

### **Disclosure Requirements**

IAS 2 sets forth certain disclosure requirements relative to inventory accounting methods employed by the reporting entity. According to this standard, the following must be disclosed:

1. The accounting policies adopted in measuring inventories, including the costing methods (e.g., FIFO or weighted-average) employed.
2. The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.
3. The carrying amount of inventories carried at fair value less costs to sell (inventories of commodity broker-traders).
4. The amount of inventories recognized as an expense during the period.
5. The amount of any write-down of inventories recognized as an expense in the period.
6. The amount of any reversal of any previous write-down that is recognized in profit or loss for the period.
7. The circumstances or events that led to the reversal of a write-down of inventories to net realizable value.
8. The carrying amount of inventories pledged as security for liabilities.

The type of information to be provided concerning inventories held in different classifications is somewhat flexible, but traditional classifications, such as raw materials, work in progress, finished goods, and supplies, should normally be employed. In the case of service providers, inventories (which are really akin to unbilled receivables) can be described as work in progress.

In addition to the foregoing, the financial statements should disclose either the cost of inventories recognized as an expense during the period (i.e., reported as cost of sales or included in other expense categories), or the operating costs, applicable to revenues, recognized as an expense during the period, categorized by their respective natures.

Costs of inventories recognized as expense includes, in addition to the costs inventoried previously and attaching to goods sold currently, the excess overhead costs charged to expense for the period because, under the standard, they could not be deferred to future periods.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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<b>Exemplum Reporting PLC</b>			
<b>Financial statements</b>			
<b>For the year ended 31 December 20XX</b>			
<b>Inventories</b>	<b>20XX</b>	<b>20XX-1</b>	IAS2 p36 p37
Raw materials	X	X	
Work in progress	X	X	
Finished goods	X	X	
<p>Inventories to the value of £ X are carried at net realizable value. Inventory written-down during the year amounted to £ X (20XX-1: £ X).</p> <p>Inventory with a carrying amount of £ X (20X-1X: £ X) has been pledged as security for liabilities. The holder of the security does not have the right to sell or re-pledge the inventory in the absence of default. <span style="float: right;">IFRS7 p14</span></p> <p>A prior year write down of inventories, amounting to £X was reversed in the year under review. This was as a result of a change in market conditions which resulted in an increased demand for the product. <span style="float: right;">IAS2 p36 (g)</span></p>			

## US GAAP COMPARISON

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Accounting for inventory under US GAAP is essentially the same except for inherent differences in measurement of costs (i.e., fair value where applicable, capitalized interest where applicable). The last-in, first-out cost method (LIFO) is permitted under US GAAP. This cost method is used primarily for oil and gas companies to minimize taxable income. The US Tax Code contains a concept called book-tax conformity that would prohibit deductions under LIFO if it is not the primary cost model.

US GAAP measures all inventory at the lower of cost or market value. Market value is the current replacement cost, but not greater than net realizable value and not less than net realizable value reduced by a normal sales margin. Net realizable value is the estimated selling price less predictable costs of completion and sale. Accounting Standard Update 2015-11, which will be effective for financial years beginning after December 15, 2016 of listed entities, requires inventory with costs determined by a method other than the LIFO or retail method to be measured at the lower of cost or net realizable value. This removes the differences between US GAAP and IFRS in the measurement of inventory with costs determined the FIFO and average cost methods. However, inventory with costs determined by the LIFO or retail method will continue to be measured at the lower of cost and market value under US GAAP.

US GAAP does not permit write-backs of previously recognized write-downs to net realizable value. The written down value is the new basis. Permanent markdowns do not affect the ratios used in applying the retail inventory method. Permanent markdowns are added to the inventory after the ratio is calculated. US GAAP does not require recognition in interim periods of inventory losses from market declines that reasonably can be expected to be restored in the fiscal year.

Unlike IAS 2, US GAAP does not require that an entity use the same formula for all inventories of a similar nature and with a similar use to the entity not present.

hand, have no physical substance. The value of an intangible asset is a function of the rights or privileges that its ownership conveys to the business entity. Intangible assets, which are explored at length in Chapter 11, can be further categorized as being either (1) identifiable, or (2) unidentifiable (i.e., goodwill), and further subcategorized as being finite-life assets and indefinite-life assets.

Long-lived assets are sometimes acquired in non-monetary transactions, either in exchanges of assets between the entity and another business organization, or else when assets are given as capital contributions by shareholders to the entity. IAS 16 requires such transactions to be measured at fair value, unless they lack commercial substance.

IFRIC 18, *Transfers of Assets from Customers* addresses situations where agreements are entered into in which an entity receives from a customer an item of property, plant and equipment that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services, or to agreements in which an entity receives cash from a customer when that amount of cash must be used only to construct or acquire an item of property, plant and equipment and the entity must then use the item of property, plant and equipment either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services.

It is increasingly the case that assets are acquired or constructed with an attendant obligation to dismantle, restore the environment, or otherwise clean up after the end of the assets' useful lives. Decommissioning costs have to be estimated at initial recognition of the asset and recognized, in most instances, as additional asset cost and as a provision, thus causing the costs to be spread over the useful lives of the assets via depreciation charges.

Measurement and presentation of long-lived assets subsequent to acquisition or construction involves both systematic allocation of cost to accounting periods, and possible special write-downs. Concerning cost allocation to periods of use, IFRS requires a "components approach" to depreciation. Thus, significant elements of an asset (in the case of a building, such components as the main structure, roofing, heating plant, and elevators, for instance) are to be separated from the cost paid for the asset, and amortized over their various appropriate useful lives.

When there is any diminution in the value of a long-lived asset, IAS 36, *Impairment of Assets*, should be applied in determining what, if any, impairment should be recognized.

Sources of IFRS			
<i>IFRS</i> 5, 8	<i>IAS</i> 16, 36, 37	<i>SIC</i> 21	<i>IFRIC</i> 1, 17, 18

## DEFINITIONS OF TERMS

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**Accumulated depreciation.** The total of all prior year deductions for depreciation taken to write off the value of a fixed asset over its estimated useful life. The accumulated depreciation account is a contra asset account, which reduces the value of total property, plant and equipment in the statement of financial position.

**Asset held for sale.** A non-current asset or a group of assets (disposal group) to be disposed of in a single transaction, together with directly associated liabilities. Assets classified as held-for-sale are not subject to depreciation and are carried at the lower of carrying amount and fair value less costs to sell. Separate classification of "assets and liabilities held for sale" in the statement of financial position is required.

**Carrying amount (book value).** The value reported for an asset or liability in the statement of financial position. Carrying amount of property, plant and equipment is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses. Carrying amount is often different from market value because depreciation is a cost allocation rather than a means of valuation.

**Cash-generating unit.** The smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows associated with other assets or groups of assets; used for impairment testing purposes.

**Commercial substance.** The ability to change an entity's future cash flows; used in determining the accounting for certain non-monetary exchanges.

**Component depreciation.** The systematic allocation of the cost of each part of an item of property, plant and equipment when this cost is significant in relation to the total cost of the item. An entity should allocate the amount initially recognized as an item of property, plant and equipment to its significant parts and depreciate separately each such part.

**Component of an entity.** Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

**Corporate assets.** Assets, excluding goodwill, that contribute to future cash flows of both the cash-generating unit under review for impairment as well as other cash-generating units of the entity.

**Cost.** Amount of cash or cash equivalent paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRSs (e.g., IFRS 2, *Share-Based Payment*).

**Costs of disposal.** The incremental costs directly associated with the disposal of an asset; these do not include financing costs or related income tax effects (IAS 36).

**Costs to sell.** The incremental costs directly attributed to a disposal of an asset (or disposal group), excluding finance costs and income tax expense (IFRS 5).

**Current asset.** An asset should be classified as a current asset when it satisfies any one of the following:

1. It is expected to be realized in, or is held for sale or consumption in, the normal operating course of the entity's operating cycle;
2. It is held primarily for trading purposes;
3. It is expected to be realized within 12 months after the reporting period; or
4. It is cash or a cash equivalent (as defined in IAS 7) that is not restricted in its use.

**Decommissioning costs.** The costs of dismantling an asset and restoring the land on which it was sited, and any other affected assets to their previous state.

**Depreciable amount.** Cost of an asset or the other amount that has been substituted for cost, less the residual value of the asset.

**Depreciation.** The process of allocating the depreciable amount (cost less residual value) of an asset over the expected useful life of the asset. This process reduces the carrying amount of an asset as a result of wear and tear, age or obsolescence, and recognizes depreciation expense in profit or loss. Similar to amortization, depreciation is a method of measuring the "consumption" of the carrying amount of long-term assets. It is not intended to be a valuation process. The amount allocated to depreciation expense is based on one of several accounting depreciation methods (IAS 16, IAS 36).



**Depreciation method.** A method of allocating the depreciable amount of an asset on a systematic basis over its useful life. IAS 16 states that the depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity, and that appropriateness of the method should be reviewed at least annually in case there has been a change in the expected pattern. Beyond that, the standard leaves the choice of method to the entity, even though it does cite the following methods; straight-line, diminishing balance, and units of production methods.

**Discontinued operation.** A component of an entity that either has been disposed of or is classified as held-for-sale and satisfies any one of the following:

1. It is a separate major line of business or geographical area of operations;
2. It is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or
3. It is a subsidiary acquired exclusively with a view to resale.

**Disposal group.** A group of assets (and liabilities associated with those assets) to be disposed of, by sale or otherwise, together as a group in a single transaction. Goodwill acquired in a business combination is included in the disposal group if this group is a cash-generating unit to which goodwill has been allocated in accordance with IAS 36 or if it is an operation within such a cash-generating unit.

**Exchange.** Reciprocal transfer between an entity and another entity that results in the acquisition of assets or services, or the satisfaction of liabilities, through a transfer of other assets, services, or other obligations.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (See Chapter 25).

**Fair value less costs to sell.** The amount obtainable from the sale of an asset in an arm's-length transaction between knowledgeable, willing parties, less the costs of disposal.

**Firm purchase commitment.** An agreement with an unrelated party, binding on both parties and usually legally enforceable, that (1) specifies all important terms, including the price and timing of the transactions, and (2) includes a disincentive for non-performance (sufficiently large) making performance highly probable.

**Highly probable.** Significantly more likely than probable.

**Impairment loss.** The excess of the carrying amount of an asset or a cash-generating unit over its recoverable amount.

**Impairment test.** Recoverability test, comparing the carrying amount of an asset in the statement of financial position to its recoverable amount to ensure that no asset is carried at more than its fair value. In general, impairment occurs when a company can no longer generate sufficient future cash inflows to recover the value of an asset.

**Intangible assets.** Identifiable non-monetary assets, without physical substance.

**Monetary assets.** Money held and assets to be received in fixed or determinable amounts of money. Examples are cash, accounts receivable and notes receivable.

**Non-current asset.** An asset not meeting the definition of a current asset.

**Non-monetary assets.** Assets other than monetary assets. Examples are inventories; investments in equity instruments; and property, plant and equipment.

**Non-monetary transactions.** Exchanges and non-reciprocal transfers that involve little or no monetary assets or liabilities.

**Non-reciprocal transfer.** Transfer of assets or services in one direction, either from an entity to its owners or another entity, or from owners or another entity to the entity. An entity's reacquisition of its outstanding stock is a non-reciprocal transfer.

**Probable.** More likely than not.

**Property, plant and equipment.** Tangible assets that are expected to be used during more than one period, and that are held for use in the process of producing goods or services for sale, or for rental to others, or for administrative purposes; also referred to as fixed assets.

**Provision.** A liability established to recognize a probable outflow of resources, whose timing or value is uncertain, where the reporting entity has a present obligation arising out of a past event.

**Qualifying asset.** An asset that necessarily requires a substantial period of time to get ready for its intended use or sale. (See Chapter 10.)

**Recoverable amount.** The greater of an asset's fair value less costs to sell or its value in use.

**Residual (salvage) value.** Estimated amount that an entity would currently obtain from disposal of the asset, net of estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Similar productive assets.** Productive assets that are of the same general type, that perform the same function, or that are employed in the same line of business.

**Useful life.** Period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by an entity.

**Value in use.** The present value of estimated future cash flows expected to be realized from the continuing use of an asset and from its disposal at the end of its useful life.

## RECOGNITION AND MEASUREMENT

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### Property, Plant and Equipment

Property, plant and equipment (also variously referred to as plant assets, fixed tangible assets, fixed assets or PPE) is the term most often used to denote tangible assets to be used in the production or supply of goods or services, for rental to others, or for administrative purposes and that will benefit the entity during more than one accounting period. This term is meant to distinguish these assets from intangibles, which are long-term, non-monetary identifiable assets that do not have physical substance, or whose value is not fully indicated by their physical existence. Property, plant and equipment does not include biological assets related to agricultural activity and mineral rights and mineral reserves (which subject matter is covered in Chapters 31 and 32 respectively). An item of property, plant and equipment should be recognized as an asset only if two conditions are met: (1) it is probable that future economic benefits associated with this item will flow to the entity, and (2) the cost of this item can be determined reliably. Spare parts and servicing equipment are usually carried as inventory and expensed as consumed. However, major spare parts and standby equipment may be used during more than one period, thereby being similar to other items of property, plant and equipment. The 2011 Improvements Project amended IAS 16 to clarify that major spare parts and standby equipment are recognized as property, plant and equipment if they meet the definition of property, plant and equipment, failing which they are recognized as inventories under IAS 2.

There are four concerns to be addressed in accounting for long-lived assets:

1. The amount at which the assets should be recorded initially on acquisition;
2. How value changes subsequent to acquisition should be reflected in the financial statements, including questions of both value increases and possible decreases due to impairments;
3. The rate at which the amount the assets are recorded should be allocated as an expense to future periods; and
4. The recording of the ultimate disposal of the assets.

### ***Initial measurement***

All costs required to bring an asset into working condition should be recorded as part of the cost of the asset. Elements of such costs include:

1. Its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
2. Any directly attributable costs incurred to bring the asset to the location and operating condition as expected by management, including the costs of site preparation, delivery and handling, installation, set-up and testing; and
3. Estimated costs of dismantling and removing the item and restoring the site.

These costs are capitalized and are not to be expensed in the period in which they are incurred, as they are deemed to add value to the asset and were necessary expenditures in acquiring the asset.

The costs required to bring acquired assets to the place where they are to be used includes such ancillary costs as testing and calibrating, where relevant. IAS 16 aims to draw a distinction between the costs of getting the asset to the state in which it is in a condition to be exploited (which are to be included in the asset's carrying amount) and costs associated with the start-up operations, such as staff training, down time between completion of the asset and the start of its exploitation, losses incurred through running at below normal capacity etc., which are considered to be operating expenses. Any revenues that are earned from the asset during the installation process are netted off against the costs incurred in preparing the asset for use. As an example, the standard cites the sales of samples produced during this procedure.

IAS 16 distinguishes the situation described in the preceding paragraph from other situations where incidental operations unrelated to the asset may occur before or during the construction or development activities. For example, it notes that income may be earned through using a building site as a car parking lot until construction begins. Because incidental operations such as this are not necessary to bring the asset to the location and working condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are to be recognized in current earnings, and included in their respective classifications of income and expense in profit or loss. These are not to be presented net, as in the earlier example of machine testing costs and sample sales revenues.

Administrative costs, as well as other types of overhead costs, are not normally allocated to fixed asset acquisitions, despite the fact that some such costs, such as the salaries of the personnel who evaluate assets for proposed acquisitions, are in fact incurred as part of the acquisition process. As a general principle, administrative costs are expensed in the period

incurred, based on the perception that these costs are fixed and would not be avoided in the absence of asset acquisitions. On the other hand, truly incremental costs, such as a consulting fee or commission paid to an agent hired specifically to assist in the acquisition, may be treated as part of the initial amount to be recognized as the asset cost.

While interest costs incurred during the construction of certain *qualifying* assets must be added to the cost of the asset under IAS 23, *Borrowing Costs* (see Chapter 10), if an asset is purchased on deferred payment terms, the interest cost, whether made explicit or imputed, is *not* part of the cost of the asset. Accordingly, such costs must be expensed currently as interest charges. If the purchase price for the asset incorporates a deferred payment scheme, only the cash equivalent price should be capitalized as the initial carrying amount of the asset. If the cash equivalent price is not explicitly stated, the deferred payment amount should be reduced to present value by the application of an appropriate discount rate. This would normally be best approximated by use of the entity's incremental borrowing cost for debt having a maturity similar to the deferred payment term, taking into account the risks relating to the asset under question that a financier would necessarily take into account.

#### ***Decommissioning cost included in initial measurement***

The elements of cost to be incorporated in the initial recognition of an asset are to include the estimated costs of its eventual dismantlement (“decommissioning costs”). That is, the cost of the asset is “grossed up” for these estimated terminal costs, with the offsetting credit being posted to a liability account. It is important to stress that recognition of a liability can only be effected when all the criteria set forth in IAS 37 for the recognition of provisions are met. These stipulate that a provision is to be recognized only when (1) the reporting entity has a present obligation, whether legal or constructive, as a result of a *past* event; (2) it is *probable* that an outflow of resources embodying economic benefits will be required to settle the obligation; and (3) a reliable estimate can be made of the amount of the obligation.

For example, assume that it were necessary to secure a government license in order to construct a particular asset, such as a power generating plant, and a condition of the license is that at the end of the expected life of the property the owner would dismantle it, remove any debris, and restore the land to its previous condition. These conditions would qualify as a present obligation resulting from a past event (the construction of the plant), which will probably result in a future outflow of resources. The cost of such future activities, while perhaps challenging to estimate due to the long time horizon involved and the possible intervening evolution of technology, can normally be accomplished with a requisite degree of accuracy. Per IAS 37, a best estimate is to be made of the future costs, which is then to be discounted to present value. This present value is to be recognized as an additional cost of acquiring the asset.

The cost of dismantlement and similar legal or constructive obligations do not extend to operating costs to be incurred in the future, since those would not qualify as “present obligations.” The precise mechanism for making these computations is addressed in Chapter 18.

If estimated costs of dismantlement, removal and restoration are included in the cost of the asset, the effect will be to allocate this cost over the life of the asset through the depreciation process. Each period the discounting of the provision should be “unwound,” such that interest cost is accreted each period. If this is done, at the expected date on which the expenditure is to be incurred it will be appropriately stated. The increase in the carrying amount of the provision should be reported as interest expense or a similar financing cost.

**Examples of decommissioning or similar costs to be recognized at acquisition**

**Example 1**—Leased premises. In accordance with the terms of a lease, the lessee is obligated to remove its specialized machinery from the leased premises prior to vacating those premises, or to compensate the lessor accordingly. The lease imposes a contractual obligation on the lessee to remove the asset at the end of the asset's useful life or upon vacating the premises, and therefore in this situation an asset (i.e., deferred cost) and liability should be recognized. If the lease is a finance lease, it is added to the asset cost; if an operating lease (less likely), a deferred charge would be reported.

**Example 2**—Owned premises. The same machinery described in Example 1 is installed in a factory that the entity owns. At the end of the useful life of the machinery, the entity will either incur costs to dismantle and remove the asset or will leave it idle in place. If the entity chooses to do nothing (i.e., not remove the equipment), this would adversely affect the fair value of the premises should the entity choose to sell the premises on an "as is" basis. Conceptually, to apply the matching principle in a manner consistent with Example 1, the cost of asset retirement should be recognized systematically and rationally over the productive life of the asset and not in the period of retirement. However, in this example, there is no *legal obligation* on the part of the owner of the factory and equipment to retire the asset and, thus, a cost would *not* be recognized at inception for this possible future loss of value.

**Example 3**—Promissory estoppel. Assume the same facts as in Example 2. In this case, however, the owner of the property sold to a third party an option to purchase the factory, exercisable at the end of five years. In offering the option to the third party, the owner verbally represented that the factory would be completely vacant at the end of the five-year option period and that all machinery, furniture and fixtures would be removed from the premises. The property owner would reasonably expect that the purchaser of the option relied to the purchaser's detriment (as evidenced by the financial sacrifice of consideration made in exchange for the option) on the representation that the factory would be vacant. While the legal status of such a promise may vary depending on local custom and law, in general this is a constructive obligation and should be recognized as a decommissioning cost and related liability.

**Example of timing of recognition of decommissioning cost**

Teradactyl Corporation owns and operates a chemical company. At its premises, it maintains underground tanks used to store various types of chemicals. The tanks were installed when Teradactyl Corporation purchased its facilities seven years prior. On February 1, 20XX, the legislature of the nation passed a law that requires removal of such tanks when they are no longer being used. Since the law imposes a legal obligation on Teradactyl Corporation, upon enactment, recognition of a decommissioning obligation would be required.

**Example of ongoing additions to the decommissioning obligation**

Jermyn Manufacturing Corporation operates a factory. As part of its normal operations it stores production by-products and used cleaning solvents on-site in a reservoir specifically designed for that purpose. The reservoir and surrounding land, all owned by Jermyn, are contaminated with these chemicals. On February 1, 20XX, the legislature of the nation enacted a law that requires cleanup and disposal of hazardous waste from existing production processes upon retirement of the facility. Upon the enactment of the law, immediate recognition would be required for the decommissioning obligation associated with the contamination that had already occurred. In addition, liabilities will continue to be recognized over the remaining life of the facility as additional contamination occurs.

### *Changes in decommissioning costs*

IFRIC 1 addresses the accounting treatment to be followed where a provision for reinstatement and dismantling costs has been created when an asset was acquired. The Interpretation requires that where estimates of future costs are revised, these should be applied prospectively only, and there is no adjustment to past years' depreciation. IFRIC 1 is addressed in Chapter 18 of this publication.

### *Initial recognition of self-constructed assets*

Essentially the same principles that have been established for recognition of the cost of purchased assets also apply to self-constructed assets. All costs that must be incurred to complete the construction of the asset can be added to the amount to be recognized initially, subject only to the constraint that if these costs exceed the recoverable amount (as discussed fully later in this chapter), the excess must be expensed as an impairment loss. This rule is necessary to avoid the "gold-plated hammer syndrome," whereby a misguided or unfortunate asset construction project incurs excessive costs that then find their way into the statement of financial position, consequently overstating the entity's current net worth and distorting future periods' earnings. Of course, internal (intragroup) profits cannot be allocated to construction costs. The standard specifies that "abnormal amounts" of wasted material, labour, or other resources may not be added to the cost of the asset.

Self-constructed assets should include, in addition to the range of costs discussed earlier, the cost of borrowed funds used during the period of construction. Capitalization of borrowing costs, as set forth by IAS 23, is discussed in Chapter 10.

### *Exchanges of assets*

IAS 16 discusses the accounting to be applied to those situations in which assets are exchanged for other similar or dissimilar assets, with or without the additional consideration of monetary assets. This topic is addressed later in this chapter, under the heading "Non-monetary (Exchange) Transactions."

### *Costs incurred subsequent to purchase or self-construction*

Costs that are incurred subsequent to the purchase or construction of the long-lived asset, such as those for repairs, maintenance or betterments, may involve an adjustment to the carrying amount, or may be expensed, depending on the precise facts and circumstances.

To qualify for capitalization, the costs must meet the recognition criteria of an asset. For example, modifications to the asset made to extend its useful life (measured either in years or in units of potential production) or to increase its capacity (e.g., as measured by units of output per hour) would be capitalized. Similarly, if the expenditure results in an improved quality of output, or permits a reduction in other cost inputs (e.g., would result in labour savings), it is a candidate for capitalization. Where a modification involves changing part of the asset (e.g., substituting a stronger power source), the cost of the part that is removed should be derecognized (treated as a disposal).

For example, roofs of commercial buildings, linings of blast furnaces used for steel making, and engines of commercial aircraft all need to be replaced or overhauled before the related buildings, furnaces or airframes themselves must be replaced. If componentized depreciation was properly employed, the roofs, linings and engines were being depreciated over their respectively shorter useful lives, and when the replacements or overhauls are

performed, on average, these will have been fully depreciated. To the extent that undepreciated costs of these components remain, they would have to be removed from the account (i.e., charged to expense in the period of replacement or overhaul) as the newly incurred replacement or overhaul costs are added to the asset accounts, in order to avoid having, for financial reporting purposes, “two roofs on one building.”

It can usually be assumed that ordinary maintenance and repair expenditures will occur on a ratable basis over the life of the asset and should be charged to expense as incurred. Thus, if the purpose of the expenditure is either to maintain the productive capacity anticipated when the asset was acquired or constructed, or to restore it to that level, the costs are not subject to capitalization.

A partial exception is encountered if an asset is acquired in a condition that necessitates that certain expenditures be incurred in order to put it into the appropriate state for its intended use. For example, a deteriorated building may be purchased with the intention that it be restored and then utilized as a factory or office facility. In such cases, costs that otherwise would be categorized as ordinary maintenance items might be subject to capitalization. Once the restoration is completed, further expenditures of similar type would be viewed as being ordinary repairs or maintenance, and thus expensed as incurred.

However, costs associated with required inspections (e.g., of aircraft) could be capitalized and depreciated. These costs would be amortized over the expected period of benefit (i.e., the estimated time to the next inspection). As with the cost of physical assets, removal of any undepreciated costs of previous inspections would be required. The capitalized inspection cost would have to be treated as a separate component of the asset.

### ***Depreciation of property, plant and equipment***

The costs of property, plant and equipment are allocated through depreciation to the periods that will have benefited from the use of the asset. Whatever method of depreciation is chosen, it must result in the systematic and rational allocation of the depreciable amount of the asset (initial cost less residual value) over the asset's expected useful life. The determination of the useful life must take a number of factors into consideration. These factors include technological change, normal deterioration, actual physical use, and legal or other limitations on the ability to use the property. The method of depreciation is based on whether the useful life is determined as a function of time or as a function of actual physical usage.

IAS 16 states that, although land normally has an unlimited useful life and is not to be depreciated, where the cost of the land includes estimated dismantlement or restoration costs, these are to be depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is to be depreciated in a manner that reflects the benefits to be derived from it.

Since, under the historical cost convention, depreciation accounting is intended as a strategy for cost allocation, it does not reflect changes in the market value of the asset being depreciated (except in some cases where the impairment rules have been applied in that way—as discussed below). Thus, with the exception of land, which has indefinite useful life, all tangible property, plant and equipment must be depreciated, even if (as sometimes occurs, particularly in periods of general price inflation) their nominal or real values increase. Furthermore, if the recorded amount of the asset is allocated over a period of time (as opposed to actual use); it should be the expected period of usefulness to the entity, not the physical or economic life of the asset itself that governs. Thus, such concerns as technological obsolescence, as well as normal wear and tear, must be addressed in the initial determination

of the period over which to allocate the asset cost. The reporting entity's strategy for repairs and maintenance will also affect this computation, since the same physical asset might have a longer or shorter useful life in the hands of differing owners, depending on the care with which it is intended to be maintained.

Similarly, the same asset may have a longer or shorter useful life, depending on its intended use. A particular building, for example, may have a 50-year expected life as a facility for storing goods or for use in light manufacturing, but as a showroom would have a shorter period of usefulness, due to the anticipated disinclination of customers to shop at entities housed in older premises. Again, it is not physical life, but useful life, that should govern.

Compound assets, such as buildings containing such disparate components as heating plant, roofs and other structural elements, are most commonly recorded in several separate accounts, to facilitate the process of depreciating the different elements over varying periods. Thus, a heating plant may have an expected useful life of 20 years, the roof a life of 15 years and the basic structure itself a life of 40 years. Maintaining separate ledger accounts eases the calculation of periodic depreciation in such situations, although for financial reporting purposes a greater degree of aggregation is usual.

IAS 16 requires a component approach for depreciation, where, as described above, each significant component of a composite asset with different useful lives or different patterns of depreciation is accounted for separately for the purpose of depreciation and accounting for subsequent expenditure (including replacement and renewal). Thus, rather than recording a newly acquired, existing office building as a single asset, it is recorded as a building shell, a heating plant, a roof, and perhaps other discrete mechanical components, subject to a materiality threshold. Allocation of cost over useful lives, instead of being based on a weighted-average of the varying components' lives, is based on separate estimated lives for each component.

IAS 16 states that the depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity, and that appropriateness of the method should be reviewed at least annually in case there has been a change in the expected pattern. Beyond that, the standard leaves the choice of method to the entity, even though it does cite straight-line, diminishing balance, and units of production as possible depreciation methods.

IAS 16 was amended effective January 1, 2016 to confirm that depreciation methods based on revenues that are generated by activities including the use of an asset are not appropriate, as revenue generally reflects factors other than the consumption of the economic benefits inherent within an asset.

### **Depreciation Methods Based on Time**

1. Straight-line—Depreciation expense is incurred evenly over the life of the asset. The periodic charge for depreciation is given as

$$\frac{\text{Cost or amount substituted for cost, less residual value}}{\text{Estimated useful life of asset}}$$

2. Accelerated methods—Depreciation expense is higher in the early years of the asset's useful life and lower in the later years. IAS 16 only mentions one accelerated method, the diminishing balance method, but other methods have been employed in various national GAAP under earlier or contemporary accounting standards.



- a. Diminishing balance—the depreciation rate is applied to the net carrying amount of the asset, resulting in a diminishing annual charge. There are various ways to compute the percentage to be applied. The formula below provides a mathematically correct allocation over useful life.

$$\text{Rate \%} = \left(1 - \sqrt[n]{\text{Residual value}}\right) \times 100$$

Where  $n$  is the expected useful life in years. However, companies generally use approximations or conventions influenced by tax practice, such as a multiple of the straight-line rate times the net carrying amount at the beginning of the year.

$$\text{Straight-line rate} = \frac{1}{\text{Estimated useful life}}$$

#### Example

Double-declining balance depreciation (if salvage value is to be recognized, stop when carrying amount = estimated salvage value)

Depreciation =  $2 \times \text{Straight-line rate} \times \text{Carrying amount at beginning of year}$

Another method to accomplish a diminishing charge for depreciation is the sum-of-the-years' digits method, which is commonly employed in the United States and certain other venues.

- b. Sum-of-the-years' digits (SYD) depreciation =  
(Cost less salvage value)  $\times$  Applicable fraction

$$\text{Where applicable fraction} = \frac{\text{Number of years of estimated life remaining as of the beginning of the year}}{\text{SYD}}$$

$$\text{and SYD} = \frac{n(n+1)}{2} \text{ and } n = \text{estimated useful life}$$

#### Example

An asset having a useful economic life of 5 years and no salvage value would have  $5/15 (= 1/3)$  of its cost allocated to year 1,  $4/15$  to year 2, and so on.

In practice, unless there are tax reasons to employ accelerated methods, large companies tend to use straight-line depreciation. This has the merit that it is simple to apply, and where a company has a large pool of similar assets, some of which are replaced each year, the aggregate annual depreciation charge is likely to be the same, irrespective of the method chosen (consider a trucking company that has 10 trucks, each costing €200,000, one of which is replaced each year: the aggregate annual depreciation charge will be €200,000 under any mathematically accurate depreciation method).

#### *Partial-year depreciation*

Although IAS 16 is silent on the matter, when an asset is either acquired or disposed of during the year, the full year depreciation calculation should be prorated between the

accounting periods involved. This is necessary to achieve proper matching. However, if individual assets in a relatively homogeneous group are regularly acquired and disposed of, one of several conventions can be adopted, as follows:

1. Record a full year's depreciation in the year of acquisition and none in the year of disposal.
2. Record one-half year's depreciation in the year of acquisition and one-half year's depreciation in the year of disposal.

#### Example of partial-year depreciation

Assume the following:

Taj Mahal Milling Co., a calendar-year entity, acquired a machine on June 1, 20XX, that cost €40,000 with an estimated useful life of four years and a €2,500 salvage value. The depreciation expense for each full year of the asset's life is calculated as follows:

	Straight-line	Double-declining balance	Sum-of-years' digits
Year 1	$€37,500^* \div 4 = €9,375$	$50\% \times €40,000 = €20,000$	$4/10 \times €37,500^* = €15,000$
Year 2	€9,375	$50\% \times €20,000 = €10,000$	$3/10 \times €37,500 = €11,250$
Year 3	€9,375	$50\% \times €10,000 = €5,000$	$2/10 \times €37,500 = €7,500$
Year 4	€9,375	$50\% \times €5,000 = €2,500$	$1/10 \times €37,500 = €3,750$
	* €40,000–€2,500.		

Because the first full year of the asset's life does not coincide with the company's fiscal year, the amounts shown above must be prorated as follows:

	Straight-line	Double-declining balance	Sum-of-years' digits
20XX	$7/12 \times 9,375 = €5,469$	$7/12 \times €20,000 = €11,667$	$7/12 \times €15,000 = € 8,750$
20XX+1	€9,375	$5/12 \times €20,000 = € 8,333$	$5/12 \times €15,000 = € 6,250$
	$7/12 \times €10,000 = € 5,833$	$7/12 \times €11,250 = € 6,563$	
		€14,166	€ 12,813
20XX+2	€9,375	$5/12 \times €10,000 = € 4,167$	$5/12 \times €11,250 = € 4,687$
	$7/12 \times €5,000 = € 2,917$	$7/12 \times € 7,500 = € 4,375$	
		€ 7,084	€ 9,062
20XX+3	€9,375	$5/12 \times €5,000 = € 2,083$	$5/12 \times € 7,500 = € 3,125$
	$7/12 \times €2,500 = € 1,458$	$7/12 \times € 3,750 = € 2,188$	
		€ 3,541	€ 5,313
20XX+4	$5/12 \times 9,375 = €3,906$	$5/12 \times €2,500 = €1,042$	$5/12 \times €3,750 = € 1,562$

#### Depreciation method based on actual physical use—units of production method

Depreciation may also be based on the number of units produced by the asset in a given year. IAS 16 identifies this as the units of production method, but it is also known as the sum of the units approach. It is best suited to those assets, such as machinery, that have an expected life that is most rationally defined in terms of productive output; in periods of reduced production (such as economic recession) the machinery is used less, thus extending the number of years it is likely to remain in service. This method has the merit that the annual depreciation expense fluctuates with the contribution made by the asset each year. Furthermore, if the depreciation finds its way into the cost of finished goods, the unit cost in periods

of reduced production would be exaggerated and could even exceed net realizable value unless the units of production approach to depreciation was taken.

$$\text{Depreciation rate} = \frac{\text{Cost less residual value}}{\text{Estimated number of units to be produced by the asset over its estimated useful life}}$$

Units of production depreciation = Depreciation rate  $\times$  Number of units produced during the period

### ***Residual value***

Most depreciation methods discussed above require that depreciation is applied not to the full cost of the asset, but to the “depreciable amount”: that is, the historical cost or amount substituted therefor (i.e., fair value) less the estimated residual value of the asset. As IAS 16 points out, residual value is often not material and in practice is frequently ignored, but it may impact upon some assets, particularly when the entity disposes of them early in their life (e.g., rental vehicles) or where the residual value is so high as to negate any requirement for depreciation (some hotel companies, for example, claim that they have to maintain their premises to such a high standard that their residual value under historical cost is higher than the original cost of the asset).

Under IAS 16, residual value is defined as the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. Residual value should, however, be measured net of any expected costs of disposal. In some cases, assets will have a negative residual value, as for example when the entity is likely to incur costs to dispose of the asset, or to return the property to an earlier condition, as in the case of certain operations, such as strip mines, that are subject to environmental protection or other laws. In such instances, periodic depreciation should total more than the asset’s original cost, such that at the expected disposal date, an estimated liability has been accrued equal to the negative residual value. The residual value is, like all aspects of the depreciation method, subject to at least annual review.

If the revaluation method of measuring property, plant and equipment is chosen, residual value must be assessed anew at the date of each revaluation of the asset. This is accomplished by using data on realizable values for similar assets, ending their respective useful lives at the time of the revaluation, after having been used for purposes similar to the asset being valued. Again, no consideration can be paid to anticipated inflation, and expected future values are not to be discounted to present values to give recognition to the time value of money.

### ***Useful lives***

Useful life is affected by such things as the entity’s practices regarding repairs and maintenance of its assets, as well as the pace of technological change and the market demand for goods produced and sold by the entity using the assets as productive inputs. If it is determined, when reviewing the depreciation method, that the estimated life is greater or less than previously believed, the change is treated as a change in accounting estimate, not as a correction of an accounting error. Accordingly, no restatement is to be made to previously reported depreciation; rather, the change is accounted for strictly on a prospective basis, being reflected in the period of change and subsequent periods.

**Example of estimating the useful life**

An asset with a cost of €100,000 was originally estimated to have a productive life of 10 years. The straight-line method is used, and there was no residual value anticipated. After 2 years, management revises its estimate of useful life to a total of 6 years. Since the net carrying amount of the asset is €80,000 after 2 years ( $= €100,000 \times 8/10$ ), and the remaining expected life is 4 years (2 of the 6 revised total years having already elapsed), depreciation in years 3 through 6 will be €20,000 ( $= €80,000/4$ ) each.

***Tax methods***

The methods of computing depreciation discussed in the foregoing sections relate only to financial reporting under IFRS. Tax laws in different nations of the world vary widely in terms of the acceptability of depreciation methods, and it is not possible to address all these. However, to the extent that depreciation allowable for income tax reporting purposes differs from that required or permitted for financial statement purposes, deferred income taxes would have to be computed. Deferred tax is discussed in Chapter 26.

***Leasehold improvements***

Leasehold improvements are improvements to property not owned by the party making these investments. For example, a lessee of office space may invest its funds to install partitions or to combine several suites by removing certain interior walls. Due to the nature of these physical changes to the property (done with the lessor's permission, of course), the lessee cannot remove or undo these changes and must abandon them upon termination of the lease, if the lessee does not remain in the facility.

A frequently encountered issue with respect to leasehold improvements relates to determination of the period over which they are to be amortized. Normally, the cost of long-lived assets is charged to expense over the estimated useful lives of the assets. However, the right to use a leasehold improvement expires when the related lease expires, irrespective of whether the improvement has any remaining useful life. Thus, the appropriate useful life for a leasehold improvement is the lesser of the useful life of the improvement or the term of the underlying lease.

Some leases contain a fixed, non-cancelable term and additional renewal options. When considering the term of the lease for the purposes of depreciating leasehold improvements, normally only the initial fixed non-cancelable term is included. There are exceptions to this general rule, however. If a renewal option is a bargain renewal option, which means that it is probable at the inception of the lease that it will be exercised and, therefore, the option period should be included in the lease term for purposes of determining the amortizable life of the leasehold improvements. Additionally, under the definition of the lease term there are other situations where it is probable that an option to renew for an additional period would be exercised. These situations include periods for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured. Other situations of this kind arise when an otherwise excludable renewal period precedes a provision for a bargain purchase of the leased asset or when, during periods covered by ordinary renewal options, the lessee has guaranteed the lessor's debt on the leased property.

**Example**

Mojo Corporation occupies a warehouse under a five-year operating lease commencing January 1, 20XX, and expiring December 31, 20XX+4. The lease contains three successive options to renew the lease for additional five-year periods. The options are not bargain renewals as they call for fixed rentals at the prevailing fair market rents that will be in effect at the time of exercise. When the initial calculation was made to determine whether the lease is an operating lease or a capital lease, only the initial non-cancelable term of five years was included in the calculation. Consequently, for the purpose of determining the depreciable life of any leasehold improvements made by Mojo Corporation, only the initial five-year term is used. If Mojo Corporation decides, at the beginning of year four of the lease, to make a substantial amount of leasehold improvements to the leased property, it could be argued that it would now be probable that Mojo would exercise one or more of the renewal periods, since not doing so would impose the substantial financial penalty for abandoning expensive leasehold improvements.

**Revaluation of Property, Plant and Equipment**

IAS 16 provides for two acceptable alternative approaches to accounting for long-lived tangible assets. The first of these is the historical cost method, under which acquisition or construction cost is used for initial recognition, subject to depreciation over the expected useful life and to possible write-down in the event of a permanent impairment in value. In many jurisdictions this is the only method allowed by statute, but a number of jurisdictions, particularly those with significant rates of inflation, do permit either full or selective revaluation and IAS 16 acknowledges this by also allowing what it calls the “revaluation model.” Under the revaluation model, after initial recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

The logic of recognizing revaluations relates to both the statement of financial position and the measure of periodic performance provided by the statement of profit or loss and other comprehensive income. Due to the effects of inflation (which even if quite moderate when measured on an annual basis can compound dramatically during the lengthy period over which property, plant and equipment remain in use) the statement of financial position can become a virtually meaningless agglomeration of dissimilar costs.

Furthermore, if the depreciation charge to income is determined by reference to historical costs of assets acquired in much earlier periods, profits will be overstated, and will not reflect the cost of maintaining the entity’s asset base. Under these circumstances, a nominally profitable entity might find that it has self-liquidated and is unable to continue in existence, at least not with the same level of productive capacity, without new debt or equity infusions. IAS 29, *Financial Reporting in Hyperinflationary Economies*, addresses adjustments to depreciation under conditions of hyperinflation.

Under the revaluation model the frequency of revaluations depends upon the changes in fair values of the items being revalued and, consequently, when the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

**Fair value**

As the basis for the revaluation method, the standard stipulates that it is fair value (defined as the price that would be received to sell an asset or paid to transfer a liability in

an orderly transaction between market participants at the measurement date) that is to be used in any such revaluations. Furthermore, the standard requires that, once an entity undertakes revaluations, they must continue to be made with sufficient regularity that the carrying amounts in any subsequent statements of financial position are not materially at variance with then-current fair values. In other words, if the reporting entity adopts the revaluation method, it cannot report obsolete fair values in the statements of financial position that contain previous years' comparative data, since that would not only obviate the purpose of the allowed treatment, but would actually make it impossible for the user to meaningfully interpret the financial statements. Accordingly, the IASB recommends that a class of assets should be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up-to-date.

Fair value is usually determined by appraisers, using market-based evidence. Market values can also be used for machinery and equipment, but since such items often do not have readily determinable market values, particularly if intended for specialized applications, they may instead be valued at depreciated replacement cost. Until recently, the term fair value was employed by several IFRS without reference to any detailed guidance as to how it is applied. This changed with the issuance of IFRS 13, *Fair Value Measurements*, in May 2011 which was effective for annual periods commencing on or after January 1, 2013. The standard is presented in further detail in Chapter 25.

#### Example of depreciated replacement cost as a valuation approach

An asset acquired January 1, 20XX, at a cost of €40,000 was expected to have a useful life of 10 years. After three years, on January 1, 20XX+3, it is appraised as having a gross replacement cost of €50,000. The depreciated replacement cost would be  $7/10 \times €50,000$ , or €35,000. This compares with carrying amount of €28,000 at that same date. Mechanically, to accomplish a revaluation at January 1, 20XX+3, the asset should be written up by €10,000 (i.e., from €40,000 to €50,000 gross cost) and the accumulated depreciation should be proportionally written up by €3,000 (from €12,000 to €15,000). Under IAS 16, the net amount of the revaluation adjustment, €7,000, would be credited to other comprehensive income and accumulated in equity as a revaluation surplus.

A recent amendment to IAS 16 has clarified that the gross value is restated (either by reference to market data or proportionally to the change in carrying amount) and that accumulated depreciation is the difference between the new gross amount and the new carrying amount.

An alternative accounting procedure is also permitted by the standard, under which the accumulated depreciation at the date of the revaluation is written off against the gross carrying amount of the asset. In the foregoing example, this would mean that the €12,000 of accumulated depreciation at January 1, 20XX+3, immediately prior to the revaluation, would be credited to the gross asset amount, €40,000, thereby reducing it to €28,000. Then the asset account would be adjusted to reflect the valuation of €35,000 by increasing the asset account by €7,000 (= €35,000 – €28,000), with the offset to other comprehensive income (and accumulated in the revaluation surplus in shareholders' equity). In terms of total assets reported in the statement of financial position, this has exactly the same effect as the first method.

### ***Revaluation applied to all assets in the class***

IAS 16 requires that if any assets are revalued, all other assets in those groupings or categories must also be revalued. This is necessary to prevent the presentation in a statement of financial position that contains an unintelligible and possibly misleading mix of historical costs and fair values, and to preclude selective revaluation designed to maximize reported net assets. Coupled with the requirement that revaluations take place with sufficient frequency to approximate fair values at the end of each reporting period, this preserves the integrity of the financial reporting process. In fact, given that a statement of financial position prepared under the historical cost method will, in fact, contain non-comparable values for similar assets (due to assets having been acquired at varying times, at differing price levels), the revaluation approach has the possibility of providing more consistent financial reporting. Offsetting this potential improvement, at least somewhat, is the greater subjectivity inherent in the use of fair values, providing an example of the conceptual framework's trade-off between relevance and reliability.

### ***Revaluation adjustments***

In general, revaluation adjustments increasing an asset's carrying amount are recognized in other comprehensive income and accumulated in equity as "*revaluation surplus*." However, the increase should be recognized in profit or loss to the extent that it reverses a revaluation decrease (impairment) of the same asset previously recognized in profit or loss. If a revalued asset is subsequently found to be impaired, the impairment loss is recognized in other comprehensive income only to the extent that the impairment loss does not exceed the amount in the revaluation surplus for the same asset. Such an impairment loss on a revalued asset is first offset against the revaluation surplus for that asset, and only when that has been exhausted, it is recognized in profit or loss.

Revaluation adjustments decreasing an asset's carrying amount, in general, are recognized in profit or loss. However, the decrease should be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity in the revaluation surplus account.

Under the provisions of IAS 16, the amount credited to revaluation surplus can either be transferred directly to retained earnings (but *not* through profit or loss!) as the asset is being depreciated, or it can be held in the revaluation surplus account until such time as the asset is disposed of or retired from service. Any transfer to retained earnings is limited to the amount equal to the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. In addition, revaluation surplus may be transferred directly to retained earnings when the asset is derecognized. This would involve transferring the whole of the surplus when the asset is retired or disposed of.

### ***Initial revaluation***

Under the revaluation model in IAS 16, at the date of initial revaluation of an item of property, plant and equipment, revaluation adjustments are accounted for as follows:

1. Increases in an asset's carrying amount are credited to other comprehensive income (gain on revaluation); and
2. Decreases in an asset's carrying amount are charged to profit or loss as this is deemed to be an impairment recognized on the related asset.

**Example—Initial revaluation**

Assume Henan Corporation (HC) acquired a plot of land with a cost of €100,000. After one year the land is appraised as having a current fair value of €110,000. The journal entry to increase the carrying amount of the land to its fair value is as follows:

Land	10,000	
Other comprehensive income—gain on revaluation		10,000

At the end of the fiscal period, the increase in the carrying amount of the land is accumulated in the “revaluation surplus” in the shareholders’ equity section of the statement of financial position.

**Subsequent revaluation**

In accordance with IAS 16, in subsequent periods, revaluation adjustments are accounted for as follows:

1. Increases in an asset’s carrying amount (upward revaluation) should be recognized as income in profit or loss to the extent of the amount of any previous impairment loss recognized, and any excess should be credited to equity through other comprehensive income;
2. Decreases in an asset’s carrying amount (downward revaluation) should be charged to other comprehensive income to the extent of any previous revaluation surplus, and any excess should be debited to profit or loss as an impairment loss.

**Example—Subsequent revaluation**

In the following year, Henan Corporation determines that the fair value of the land is no longer €110,000. Assuming the fair value decreased to €95,000, the following journal entry is made to record downward revaluation:

Other comprehensive income—loss on revaluation	10,000	
Impairment loss—land (expense)	5,000	
Land		15,000

**Methods of adjusting accumulated depreciation at the date of revaluation**

When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

1. Restate accumulated depreciation to reflect the difference between the change in the gross carrying amount of the asset and the revalued amount (so that the carrying amount of the asset after revaluation equals its revalued amount); or
2. Eliminate the accumulated depreciation against the gross carrying amount of the asset.

**Example—Accumulated depreciation**

Konin Corporation owns buildings with a cost of €200,000 and estimated useful life of five years. Accordingly, depreciation of €40,000 per year is anticipated. After two years, Konin obtains market information suggesting that a current fair value of the buildings is €300,000 and decided to write the buildings up to a fair value of €300,000. There are two approaches to apply the revaluation model in IAS 16: the asset and accumulated depreciation can be “grossed up” to reflect the new fair value information, or the asset can be restated on a “net” basis. These two approaches



are illustrated below. For both illustrations, the net carrying amount (carrying amount or depreciated cost) immediately prior to the revaluation is €120,000 [ $€200,000 - (2 \times €40,000)$ ]. The net upward revaluation is given by the difference between fair value and net carrying amount, or  $€300,000 - €120,000 = €180,000$ .

**Option 1(a).** Applying the “gross up” approach, since the fair value after two years of the five-year useful life have already elapsed is found to be €300,000, the gross fair value (gross carrying amount) calculated proportionally is  $5/3 \times €300,000 = €500,000$ . In order to have the net carrying amount equal to the fair value after two years, the balance in accumulated depreciation needs to be €200,000. Consequently, the buildings and accumulated depreciation accounts need to be restated upward as follows: buildings up €300,000 ( $€500,000 - €200,000$ ) and accumulated depreciation €120,000 ( $€200,000 - €80,000$ ). Alternatively, this revaluation could be accomplished by restating the buildings account and the accumulated depreciation account so that the ratio of net carrying amount to gross carrying amount is 60% ( $€120,000/€200,000$ ) and the net carrying amount is €300,000. New gross carrying amount is calculated  $€300,000/.60 = x$ ;  $x = €500,000$ .

The following journal entry and table illustrate the restatement of the accounts:

Buildings		300,000		
Accumulated depreciation			120,000	
Other comprehensive income—gain on revaluation			180,000	
	<u>Original cost</u>	<u>Revaluation</u>	<u>Total</u>	<u>%</u>
Gross carrying amount	€200,000	+€300,000	= €500,000	100
Accumulated depreciation	80,000	+ 120,000	= 200,000	40
Net carrying amount	€120,000	+ €180,000	= €300,000	60

After the revaluation, the carrying amount of the buildings is €300,000 ( $= €500,000 - 200,000$ ) and the ratio of net carrying amount to gross carrying amount is 60% ( $= €300,000/€500,000$ ). This method is often used when an asset is revalued by means of applying an index to determine its depreciated replacement cost.

**Option 1(b).** Applying the “gross up” approach where the gross fair value had separately been valued at €450,000 then both the Building and Accumulated depreciation entry would be reduced by €50,000 from the example above.

Buildings		250,000	
Accumulated depreciation			70,000
Other comprehensive income—gain on revaluation			180,000

**Option 2.** Applying the “netting” approach, Konin would eliminate accumulated depreciation of €80,000 and then increase the building account by €180,000 so the net carrying amount is €300,000 ( $= €200,000 - €80,000 + €180,000$ ):

Accumulated depreciation		80,000	
Buildings			80,000
Buildings		180,000	
Other comprehensive income—gain on revaluation			180,000

This method is often used for buildings. In terms of total assets reported in the statement of financial position, option 2 has exactly the same effect as option 1.

However, many users of financial statements, including credit grantors and prospective investors, pay heed to the ratio of net property and equipment as a fraction of the related gross amounts. This is done to assess the relative age of the entity’s productive assets and, indirectly, to estimate the timing and amounts of cash needed for asset replacements. There is a significant diminution of information under the second method. Accordingly, the first

approach described above, preserving the relationship between gross and net asset amounts after the revaluation, is recommended as the preferable alternative if the goal is meaningful financial reporting.

### *Deferred tax effects of revaluations*

As described in detail in Chapter 26, the tax effects of temporary differences must be provided for. Where assets are depreciated over longer lives for financial reporting purposes than for tax reporting purposes, a deferred tax liability will be created in the early years and then drawn down in later years. Generally speaking, the deferred tax provided will be measured by the expected future tax rate applied to the temporary difference at the time it reverses; unless future tax rate changes have already been enacted, the current rate structure is used as an unbiased estimator of those future effects.

In the case of revaluation of assets, it may be that taxing authorities will not permit the higher revalued amounts to be depreciated for purposes of computing tax liabilities. Instead, only the actual cost incurred can be used to offset tax obligations. On the other hand, since revaluations reflect a holding gain, this gain would be taxable if realized. Accordingly, a deferred tax liability is still required to be recognized, even though it does not relate to temporary differences arising from periodic depreciation charges.

SIC 21 confirmed that measurement of the deferred tax effects relating to the revaluation of non-depreciable assets must be made with reference to the tax consequences that would follow from recovery of the carrying amount of that asset through an eventual sale. This is necessary because the asset will not be depreciated, and hence, no part of its carrying amount is considered to be recovered through use. As a practical matter this means that if there are differential capital gain and ordinary income tax rates, deferred taxes will be computed with reference to the former. This guidance of SIC 21 has now been incorporated into IAS 12 as part of a December 2010 amendment, which became effective for annual periods commencing on or after January 1, 2012. SIC 21 was consequently withdrawn with effect from that date.

## **DERECOGNITION**

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An entity should derecognize an item of property, plant and equipment (1) on disposal, or (2) when no future economic benefits are expected from its use or disposal. In such cases an asset is removed from the statement of financial position. In the case of property, plant and equipment, both the asset and the related contra asset, accumulated depreciation, should be eliminated. The difference between the net carrying amount and any proceeds received will be recognized immediately as a gain or loss arising on derecognition.

If the revaluation method of accounting has been employed, and the asset and the related accumulated depreciation account have been adjusted upward, if the asset is subsequently disposed of before it has been fully depreciated, the gain or loss computed will be identical to what would have been determined had the historical cost method of accounting been used. The reason is that, at any point in time, the net amount of the revaluation (i.e., the step-up in the asset less the unamortized balance in the step-up in accumulated depreciation) will be offset exactly by the remaining balance in the revaluation surplus account. Elimination of the asset, contra asset, and revaluation surplus accounts will balance precisely, and there will be no gain or loss on this aspect of the disposition transaction. The gain or loss will be determined exclusively by the discrepancy between the net carrying amount, based on

historical cost, and the proceeds from the disposition. Thus, the accounting outcome is identical under cost and revaluation methods.

**Example of accounting for asset disposal**

On January 1, 20XX, Zara Corp. acquired a machine at a cost of €12,000; it had an estimated life of six years, no residual value, and was expected to provide a level pattern of utility to the entity. Thus, straight-line depreciation in the amount of €2,000 was charged to operations. At the end of four years, the asset was sold for €5,000. Accounting was done on a historical cost basis. The entries to record depreciation and to report the ultimate disposal on January 1, 20XX+4, are as follows:

1/1/20XX Machinery	12,000	
Cash, etc.		12,000
12/31/20XX Depreciation expense	2,000	
Accumulated depreciation		2,000
12/31/20XX+1 Depreciation expense	2,000	
Accumulated depreciation		2,000
12/31/20XX+2 Depreciation expense	2,000	
Accumulated depreciation		2,000
12/31/20XX+3 Depreciation expense	2,000	
Accumulated depreciation		2,000
1/1/20XX+4 Cash	5,000	
Accumulated depreciation	8,000	
Machinery		12,000
Gain on asset disposal		1,000

Now assume the same facts as above, but that the revaluation method is used. At the beginning of year four (20XX+3) the asset is revalued at a gross replacement cost of €7,500. A year later it is sold for €5,000. The entries are as follows (note in particular that the remaining revaluation surplus is transferred directly to retained earnings):

1/1/20XX Machinery	12,000	
Cash, etc.		12,000
12/31/20XX Depreciation expense	2,000	
Accumulated depreciation		2,000
12/31/20XX+1 Depreciation expense	2,000	
Accumulated depreciation		2,000
12/31/20XX+2 Depreciation expense	2,000	
Accumulated depreciation		2,000
1/1/20XX+3 Machinery	3,000	
Accumulated depreciation		1,500
		1,500
	Other comprehensive income – revaluation surplus	
12/31/20XX+3 Depreciation expense	2,500	
Accumulated depreciation		2,500
Revaluation surplus	500	
Retained earnings		500
1/1/20XX+4 Cash	5,000	
Accumulated depreciation	10,000	
Revaluation surplus	1,000	
Machinery		15,000
Retained earnings		1,000

## NON-CURRENT ASSETS HELD FOR SALE

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As part of its ongoing efforts to converge IFRS with US GAAP, the IASB issued IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. This introduced new and substantially revised guidance for accounting for long-lived tangible (and other) assets that have been identified for disposal, as well as new requirements for the presentation and disclosure of discontinued operations.

IFRS 5 states that where management has decided to sell an asset, or disposal group, these should be classified in the statement of financial position as “held-for-sale” and should be measured at the lower of carrying amount or fair value less cost to sell. After reclassification, these assets will no longer be subject to systematic depreciation. The measurement basis for non-current assets classified as held-for-sale is to be applied to the group as a whole, and any resulting impairment loss will reduce the carrying amount of the non-current assets in the disposal group.

Assets and liabilities which are to be disposed of together in a single transaction are to be treated as a *disposal group*. In accordance with the standard, a disposal group is a group of assets (and liabilities directly associated with those assets) to be disposed of, by sale or otherwise, together as a group in a single transaction. Goodwill acquired in a business combination is included in the disposal group if this group is a cash-generating unit to which goodwill has been allocated in accordance with IAS 36 or if it is an operation within such a cash-generating unit.

IFRIC 17, *Distributions of Non-cash Assets to Owners*, provides guidance on the appropriate accounting treatment when an entity distributes assets other than cash as dividends to its shareholders. As part of the issuance of IFRIC 17, IFRS 5 was amended to include non-cash assets held for distribution to owners as part of IFRS 5 and should be treated in accordance with IFRS 5’s classification, presentation and measurement requirements. Whether or not a non-cash asset is classified as ‘held for distribution to owners’ is determined using the principles in IFRS 5 detailed below.

### *Held-for-sale classification*

The reporting entity would classify a non-current asset (or disposal group) as held-for-sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. The criteria are as follows:

1. For an asset or disposal group to be classified as held-for-sale, the asset (or asset group) must be available for immediate sale in its present condition and its sale must be *highly probable*.
2. In addition, the asset (or disposal group) must be currently being marketed actively at a price that is reasonable in relation to its current fair value.
3. The sale should be completed, or expected to be so, within 12 months from the date of the classification. IFRS 5 does however allow for some exceptions to this principle, which are discussed below.
4. The actions required to complete the planned sale will have been made, and it is unlikely that the plan will be significantly changed or withdrawn. For this purpose, factors such as, for example, shareholders’ approval should be considered as part of the assessment of whether the sale is highly probable.
5. For the sale to be highly probable, management must be committed to selling the asset and must be actively looking for a buyer.

6. In the case that the sale may not be completed within 12 months, the asset could still be classified as held-for-sale if the delay is caused by events beyond the entity's control and the entity remains committed to selling the asset.

Extension of the period beyond 12 months is allowable in the following situations:

- The reporting entity has committed itself to sell an asset, and it expects that others may impose conditions on the transfer of the asset that could not be completed until after a firm purchase commitment has been made, and a firm purchase commitment is highly probable within a year.
- A firm purchase commitment is made but a buyer unexpectedly imposes conditions on the transfer of the asset held for sale; timely actions are being taken to respond to the conditions, and a favourable resolution is anticipated.
- During the one-year period, unforeseen circumstances arise that were considered unlikely, and the asset is not sold. Necessary action to respond to the change in circumstances should be taken. The asset should be actively marketed at a reasonable price and the other criteria set out for the asset to be classified as held-for-sale should have been met.

Occasionally companies acquire non-current assets exclusively with a view to disposal. In these cases, the non-current asset will be classified as held-for-sale at the date of the acquisition only if it is anticipated that it will be sold within the one-year period and it is highly probable that the held-for-sale criteria will be met within a short period of the acquisition date. This period normally will be no more than three months. Exchanges of non-current assets between companies can be treated as held-for-sale when such an exchange has commercial substance in accordance with IAS 16.

If the criteria for classifying a non-current asset as held-for-sale occur *after* the reporting date, the non-current asset should *not* be presented as held-for-sale. Nonetheless, certain information should be disclosed about these non-current assets.

Operations that are expected to be wound down or abandoned do not meet the definition of held for sale. However, a disposal group that is to be abandoned may meet the definition of a discontinued activity. *Abandonment* means that the non-current asset (disposal group) will be used to the end of its economic life, or the non-current asset (disposal group) will be closed rather than sold. The reasoning behind this is that the carrying amount of the non-current asset will be recovered principally through continued usage. A non-current asset that has been temporarily taken out of use or service cannot be classified as being abandoned.

### ***Measurement of non-current assets held for sale***

Assets that are classified as being held for disposal are measured differently and presented separately from other non-current assets. In accordance with IFRS 5, the following general principles would apply in measuring non-current assets that are held for sale:

- Just before an asset is initially classified as held-for-sale, it should be measured in accordance with the applicable IFRS.
- When non-current assets or disposal groups are classified as held-for-sale, they are measured at the *lower of the carrying amount and fair value less costs to sell*.
- When the sale is expected to occur in greater than a year's time, the entity should measure the cost to sell at its present value. Any increase in the present value of the

cost to sell that arises from the passage of time should be shown in profit and loss as finance cost.

- Any impairment loss is recognized in profit or loss on any initial or subsequent write-down of the asset or disposal group to fair value less cost to sell.
- Any subsequent increases in fair value less cost to sell of an asset can be recognized in profit or loss to the extent that it is *not in excess of the cumulative impairment loss* that has been recognized in accordance with IFRS 5 (or previously in accordance with IAS 36).
- Any impairment loss recognized for a disposal group should be applied in the order set out in IAS 36.
- Non-current assets or disposal groups classified as held-for-sale should not be depreciated.

Any interest or expenses of a disposal group should continue to be provided for.

The standard stipulates that, for assets not previously revalued (under IAS 16), any recorded decrease in carrying amount (to fair value less cost to sell or value in use) would be an impairment loss taken as charge against income; subsequent changes in fair value would also be recognized, but not increases in excess of impairment losses previously recognized.

For an asset that is carried at a revalued amount (as permitted under IAS 16), revaluation under that standard will have to be effected immediately before it is reclassified as held-for-sale under this proposed standard, with any impairment loss recognized in profit or loss. Subsequent increases or decreases in estimated costs to sell the asset will be recognized in profit or loss. On the other hand, decreases in estimated fair value would be offset against revaluation surplus created under IAS 16, (recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus), and subsequent increases in fair value would be recognized in full as a revaluation increase under IAS 16, identical to the accounting required before the asset was reclassified as held-for-sale.

A disposal group, as defined under IFRS 5, may include some assets which had been accounted for by the revaluation method. For such disposal groups subsequent increases in fair value are to be recognized, but only to the extent that the carrying amounts of the non-current assets in the group, after the increase has been allocated, do not exceed their respective fair value less costs to sell. The increase recognized would continue to be treated as a revaluation increase under IAS 16.

Finally, IFRS 5 states that non-current assets classified as held-for-sale are not to be depreciated. This is logical: the concept objective of depreciation accounting is to allocate asset cost to its useful economic life, and once an asset is denoted as being held for sale, this purpose is no longer meaningful. The constraints on classifying an asset as held-for-sale are, in part, intended to prevent entities from employing such reclassification as a means of avoiding depreciation. Even after classification as held-for-sale, however, interest and other costs associated with the asset are still recognized as expenses as required under IFRS.

### ***Change of plans***

If the asset held for sale is not later disposed of, it is to be reclassified to the operating asset category it is properly assignable to. The amount to be initially recognized upon such reclassification would be the lower of:

1. The asset's carrying amount before the asset (or disposal group) was classified as held-for-sale, adjusted for any depreciation or amortization that would have been

recognized during the interim had the asset (disposal group) not been classified as held-for-sale; and

2. The *recoverable amount* at the date of the subsequent decision not to sell.

If the asset is part of a cash-generating unit (as defined under IAS 36), its recoverable amount will be defined as the carrying amount that would have been recognized after the allocation of any impairment loss incurred from that same cash-generating unit.

Under the foregoing circumstance, the reporting entity would include, as part of income from continuing operations in the period in which the criteria for classification as held-for-sale are no longer met, any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held-for-sale. That adjustment would be presented in income from continuing operations. It is not an adjustment to prior period results of operations under any circumstances.

If an individual asset or liability is removed from a disposal group classified as held-for-sale, the remaining assets and liabilities of the disposal group still to be sold will continue to be measured as a group only if the group meets the criteria for categorization as held-for-sale. In other circumstances, the remaining non-current assets of the group that individually meet the criteria to be classified as held-for-sale will need to be measured individually at the lower of their carrying amounts or fair values less costs to sell at that date.

### ***Presentation and disclosure***

IFRS 5 specifies that non-current assets classified as held-for-sale and the assets of disposal group classified as held-for-sale must be presented separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held-for-sale are also presented separately from other liabilities in the statement of financial position.

Several disclosures are required, including a description of the non-current assets of a disposal group, a description of the facts and circumstances of the sale, and the expected manner and timing of that disposal. Any gain or loss recognized for impairment or any subsequent increase in the fair value less costs to sell should also be shown in the applicable segment in which the non-current assets or disposal group is presented in accordance with IFRS 8 (Chapter 28).

IFRS 5 was amended in the 2009 Improvements Project and now specifies the disclosures required in respect of non-current assets (or disposal groups) classified as held-for-sale or discontinued operations. It provides that the disclosure requirements in other IFRS do not apply to such assets (or disposal groups) unless those IFRS require:

1. Specific disclosures in respect of non-current assets (or disposal groups) classified as held-for-sale or discontinued operations; or
2. Disclosures about measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of IFRS 5 and such disclosures are not already provided in the other notes to the financial statements.

It also provides that where additional disclosures about non-current assets (or disposal groups) classified as held-for-sale or discontinued operations are necessary in order to comply with the general requirements of IAS 1, then such disclosures must still be made.

## **DISCLOSURES**

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The disclosures required under IAS 16 for property, plant and equipment, and under IAS 38 for intangibles, are similar. Furthermore, IAS 36 requires extensive disclosures when

assets are impaired or when formerly recognized impairments are being reversed. The requirements that pertain to property, plant and equipment are as follows:

For each class of tangible asset, disclosure is required of:

1. The measurement basis used (cost or revaluation approaches).
2. The depreciation method(s) used.
3. Useful lives or depreciation rates used.
4. The gross carrying amounts and accumulated depreciation at the beginning and at the end of the period.
5. A reconciliation of the carrying amount from the beginning to the end of the period, showing additions, dispositions, acquisitions by means of business combinations, increases or decreases resulting from revaluations, reductions to recognize impairments, amounts written back to recognize recoveries of prior impairments, depreciation, the net effect of translation of foreign entities' financial statements, and any other material items. (An example of such a reconciliation is presented below.) This reconciliation need be provided for only the current period even if comparative financial statements are being presented.

In addition, the financial statements should also disclose the following facts:

1. Any restrictions on titles and any assets pledged as security for debt.
2. The accounting policy regarding restoration costs for items of property, plant and equipment.
3. The expenditures made for property, plant and equipment, including any construction in progress.
4. The amount of outstanding commitments for property, plant and equipment acquisitions.

#### Example of reconciliation of asset carrying amounts

<i>Date</i>	<i>Gross cost</i>	<i>Accumulated depreciation</i>	<i>Net carrying amount</i>
1/1/15	€4,500,000	€2,000,000	€2,500,000
Acquisitions	3,000,000	—	3,000,000
Disposals	(400,000)	(340,000)	(60,000)
Impairment	—	600,000	(600,000)
Depreciation	—	200,000	(200,000)
12/31/15	<u>€7,100,000</u>	<u>€2,460,000</u>	<u>€4,640,000</u>

#### Non-Monetary (Exchange) Transactions

Businesses sometimes engage in non-monetary exchange transactions, where tangible or intangible assets are exchanged for other assets, without a cash transaction or with only a small amount of cash “settle-up.” These exchanges can involve productive assets such as machinery and equipment, which are not held for sale under normal circumstances, or inventory items, which are intended for sale to customers.

IAS 16 provides guidance on the accounting for non-monetary exchanges of tangible assets. It requires that the cost of an item of property, plant and equipment acquired in exchange for a similar asset is to be measured at fair value, provided that the transaction has commercial substance. The concept of a purely “book value” exchange, formerly employed, is now prohibited under most circumstances.



Commercial substance is a relatively new notion under IFRS, and is defined as the event or transaction causing the cash flows of the entity to change. That is, if the expected cash flows after the exchange differ from what would have been expected without this occurring, the exchange has commercial substance and is to be accounted for at fair value. In assessing whether this has occurred, the entity has to consider if the amount, timing and uncertainty of the cash flows from the new asset are different from the one given up, or if the entity-specific portion of the company's operations will be different. If either of these is significant, then the transaction has commercial substance.

If the transaction does not have commercial substance, or the fair value of neither the asset received nor the asset given up can be measured reliably, then the asset acquired is valued at the carrying amount of the asset given up. Such situations are expected to be rare.

If there is a settle-up paid or received in cash or a cash equivalent, this is often referred to as boot; that term will be used in the following example.

**Example of an exchange involving dissimilar assets and no boot**

Assume the following:

1. Jamok, Inc. exchanges an automobile with a carrying amount of €2,500 with Springsteen & Co. for a tooling machine with a fair market value of €3,200.
2. No boot is exchanged in the transaction.
3. The fair value of the automobile is not readily determinable.

In this case, Jamok, Inc. has recognized a gain of €700 (= €3,200 – €2,500) on the exchange, and the gain should be included in the determination of net income. The entry to record the transaction would be as follows:

Machine	3,200	
Automobile		2,500
Gain on exchange of automobile		700

***Non-reciprocal transfers***

In a non-reciprocal transfer, one party gives or receives property without the other party doing the opposite. Often these involve an entity and the owners of the entity. Examples of non-reciprocal transfers with owners include dividends paid-in-kind, non-monetary assets exchanged for common stock, split-ups, and spin-offs. An example of a non-reciprocal transaction with parties other than the owners is a donation of property either by or to the entity.

The accounting for most non-reciprocal transfers should be based on the fair market value of the asset given (or received, if the fair value of the non-monetary asset is both objectively measurable and would be clearly recognizable under IFRS). The same principle also applies to distributions of non-cash assets (e.g., items of property, plant and equipment, businesses as defined in IFRS 3, ownership interest in another entity, or disposal groups as defined in IFRS 5); and also to distributions that give owners a choice of receiving either non-cash assets or a cash alternative. IFRIC 17 was issued in January 2009 to address the accounting that should be followed in such situations and provides that the assets involved must be measured at their fair value and any gains or losses taken to profit or loss. The Interpretation also provides guidance on the measurement of the dividend payable in that the dividend payable is measured at the fair value of the assets to be

distributed. If the entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity should estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative. At the end of each reporting period and at the date of settlement, the entity is required to review and adjust the carrying amount of the dividend payable, with any changes in the carrying amount of the dividend payable recognized in equity as adjustments to the amount of the distribution.

This approach differs from the previous approach, which permitted the recording of transactions that resulted in the distribution of non-monetary assets to owners of an entity in a spin-off or other form of reorganization or liquidation being accounted for based on their recorded amount.

#### Example of accounting for a non-reciprocal transfer

Assume the following:

1. Salaam distributed property with a carrying amount of €10,000 to its shareholder as a dividend during the current year.
2. The property had a fair market value of €17,000 at the date of the transfer.

The transaction is to be valued at the fair market value of the property transferred, and any gain or loss on the transaction is to be recognized. Thus, Salaam should recognize a gain of €7,000 (= €17,000 – €10,000) in the determination of the current period's profit or loss. The entry to record the transaction would be as follows:

Dividend paid	17,000	
Property		10,000
Gain on transfer of property		7,000

#### Transfers of Assets from Customers

IFRIC 18, *Transfers of Assets from Customers*, addresses the accounting that must be applied to transfers of items of property, plant and equipment by entities that receive such transfers from their customers. The Interpretation addresses agreements in which the entity receives from a customer an item of property, plant and equipment that it must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services, or to do both. This Interpretation also applies to agreements in which the entity, rather than receiving property, plant and equipment, instead receives cash from a customer and that amount of cash must be used only to construct or acquire an item of property, plant and equipment that will then be used in the delivery of goods and services to the customer. The Interpretation does not apply to agreements in which the transfer is either a government grant as defined in IAS 20 or infrastructure used in a service concession arrangement that is within the scope of IFRIC 12.

Where an asset is received, such asset is accounted for at its fair value, provided that it meets the definition of an asset as contained in the *Framework*. Simultaneously, the entity must identify its obligations to its customer and identify the credit side of the transaction as an obligation to provide goods and services. Revenue from the rendering of such goods and services will then be recognized over the period of time that the obligation is discharged, in accordance with the terms of the agreement entered into with the customer.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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### Exemplum Reporting PLC

#### Financial statements

For the year ended 31 December 20XX

#### Summary of significant accounting policies

##### 2.5 Property, plant and equipment

All property, plant and equipment assets are stated at cost less accumulated depreciation. IAS16 p30

Depreciation of property, plant and equipment is provided to write off the cost, less residual value, on a straight line basis over the estimated useful life. IAS16 p73

- Buildings - 50 years
- Computer equipment - 3 years
- Motor vehicles - 5 years

Residual values, remaining useful lives and depreciation methods are reviewed annually and adjusted if appropriate. IAS16 p51

Gains or losses on disposal are included in profit or loss IAS16 p68

##### 2.16 Discontinued operations and non-current assets held for sale

The results of discontinued operations are to be presented separately in the statement of comprehensive income. IFRS5 p1

Non-current assets (or disposal group) classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. IFRS5 p15

Non-current assets (or disposal group) are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. IFRS5 p6

This is the case, when the asset (or disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and the sale is considered to be highly probable. IFRS5 p7

A sale is considered to be highly probable if the appropriate level of management is committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan has been initiated. Further, the asset (or disposal group) has been actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale is expected to qualify for recognition as a completed sale within one-year from the date that it is classified as held for sale. IFRS5 p8

##### 3. Accounting estimates and judgements

The estimates and judgements that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are as follows: IAS1 p122 p125

##### 3.1 Key sources of estimation uncertainty

**Useful lives of items of property, plant and equipment** IAS1 p129

The group reviews the estimated useful lives of property, plant and equipment at the end of each reporting period. During the current year, the directors determined that the useful lives of certain items of equipment should be shortened, due to developments in technology.

The financial effect of this reassessment is to increase the consolidated depreciation expense in the current year and for the next 3 years, by the following amounts:

20XX	£X
20XX+1	£X
20XX+2	£X
20XX+3	£X

**15. Property, Plant and Equipment**

<b>Group</b>	<b>Land and Buildings</b>	<b>Plant and Machinery</b>	<b>Furniture and fittings</b>	<b>Total</b>	IAS16 p73
<b>Cost</b>					
Opening cost at 1 January 20XX-1	X	X	X	X	
Additions	X	X	X	X	
Exchange differences	X	X	X	X	
Classified as held for sale					
Disposals	X	X	X	X	
Acquired through business combination	X	X	X	X	
Opening cost at 1 January 20XX	X	X	X	X	
Additions	X	X	X	X	
Exchange differences	X	X	X	X	
Classified as held for sale					
Disposals	X	X	X	X	
Acquired through business combination	X	X	X	X	
<b>Closing cost at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	
<b>Accumulated depreciation/ impairment</b>					
Opening balance at 1 January 20XX-1	X	X	X	X	
Depreciation	X	X	X	X	
Disposals	X	X	X	X	
Exchange differences	X	X	X	X	
Impairment loss	X	X	X	X	
Opening balance at 1 January 20XX	X	X	X	X	
Depreciation	X	X	X	X	
Disposals	X	X	X	X	
Exchange differences	X	X	X	X	
Impairment loss	X	X	X	X	
Impairment reversal	X	X	X	X	
<b>Closing balance at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	
Opening carrying value at 1 January 20XX-1	X	X	X	X	
Opening carrying value at 1 January 20XX	X	X	X	X	
<b>Closing carrying value at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	

Plant and machinery includes the following amounts where the group is a lessee under a finance lease:

IAS 17 p31(a)

	20XX	20XX-1
Cost - capitalized finance leases	X	X
Accumulated depreciation	X	X
Net book value	X	X

In determining the valuations for land and buildings, the valuer refers to current market conditions including recent sales transactions of similar properties - assuming the highest and best use of the properties.

For plant and machinery, current replacement cost adjusted for the depreciation factor of the existing assets is used. There has been no change in the valuation technique used during the year compared to prior periods.

The fair valuation of property, plant and equipment is considered to represent a level 3 valuation based on significant non-observable inputs being the location and condition of the assets and replacement costs for plant & machinery.

Management does not expect there to be a material sensitivity to the fair values arising from the non-observable inputs.

There were no transfers between level 1, 2 or 3 fair values during the year.

The table above presents the changes in the carrying value of the property, plant and equipment arising from these fair valuation assessments.

## US GAAP COMPARISON

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US GAAP and IFRS are very similar with regard to property, plant and equipment. Generally, expenditures that qualify for capitalization under IFRS are also eligible under US GAAP.

Initial measurement can differ for internally constructed assets. US GAAP permits only eligible interest to be capitalized, whereas IFRS includes other borrowing costs. There are also some differences regarding what borrowings are included to compute a capitalization rate. For costs connected to a specific asset, borrowing costs equal the weighted-average of accumulated expenditures times the borrowing rate.

Component accounting is not prescribed under US GAAP, but neither is it prohibited, and it is not common. This disparity can result in a different “mix” of depreciation and maintenance expense on the income statement. Only major upgrades to PPE are capitalized under US GAAP, whereas the replacement of a component under IFRS is characterized as accelerated depreciation and additional capital expenditures. Consequently, the classification of expenditures on the statement of cash flows can differ.

Most oil and gas companies use US GAAP for exploration assets since there is no substantial IFRS for the oil and gas industry. IFRS 6 permits entities to disregard the hierarchy of application prescribed in IAS 8 and use another standard (usually US GAAP) immediately.

The accounting for asset retirement obligations assets is largely the same but the difference in the discount rate used to measure the fair value of the liability creates an inherent difference in the carrying cost. US GAAP uses a credit-adjusted, risk-free rate adjusted for the entity's credit risk to discount the obligation. IFRS uses the time value of money rate adjusted for specific risks of the liability. Also, assets and obligations are not adjusted for period-to-period changes in the discount. The discount rate applied to each upward revisions of an accrual, termed “layers” in US GAAP, remains with that layer through increases and decreases.

US GAAP requires a two-step method approach to impairment measuring. If the asset fails the first step (future undiscounted cash flows exceed the carrying amount), the second step requires an impairment loss calculated as the excess of carrying amount over fair value.

US GAAP does not permit revaluations of property, plant and equipment or mineral resources.

	Land and buildings £m	Equipment, fixtures and fittings £m	Total £m
<b>Cost:</b>			
1 April 2013	1,731	47,038	48,769
Exchange movements	(89)	(2,933)	(3,022)
Arising on acquisition	2	5	7
Additions	140	4,562	4,702
Disposals	(29)	(1,458)	(1,487)
Disposals of subsidiaries and joint ventures	--	(604)	(604)
Other	(53)	(45)	(98)
<b>31 March 2014</b>	<b>1,702</b>	<b>46,565</b>	<b>48,267</b>
Exchange movements	(16)	96	80
Arising on acquisition	52	1,503	1,555
Additions	143	4,545	4,688
Disposals	(30)	(2,577)	(2,607)
Disposals of subsidiaries and joint ventures	(1)	(28)	(29)
Other	37	(143)	(106)
<b>31 March 2015</b>	<b>1,887</b>	<b>49,961</b>	<b>51,848</b>
<b>Accumulated depreciation and impairment:</b>			
1 April 2013	709	27,879	28,588
Exchange movements	(33)	(1,652)	(1,685)
Charge for the year	98	4,265	4,363
Impairment losses	--	81	81
Disposals	(23)	(1,252)	(1,275)
Disposals of subsidiaries and joint ventures	--	(400)	(400)
Other	--	(60)	(60)
<b>31 March 2014</b>	<b>751</b>	<b>28,861</b>	<b>29,612</b>
Exchange movements	4	197	201
Charge for the year	122	4,131	4,253
Disposals	(24)	(2,391)	(2,415)
Disposals of subsidiaries and joint ventures	(1)	(14)	(15)
Other	31	(150)	(119)
<b>31 March 2015</b>	<b>883</b>	<b>30,634</b>	<b>31,517</b>
<b>Net book value:</b>			
<b>31 March 2014</b>	<b>951</b>	<b>17,704</b>	<b>18,655</b>
<b>31 March 2015</b>	<b>1,004</b>	<b>19,327</b>	<b>20,331</b>

\* The net book value of land and buildings and equipment, fixtures and fittings includes £62 million and £385 million respectively (2014 £58 million and £233 million) in relation to assets held under finance leases. Included in the net book value of land and buildings and equipment, fixtures and fittings are assets in the course of construction, which are not depreciated, with a cost of £18 million and £2,377 million respectively (2014: £28 million and £2,037 million). Property, plant and equipment with a net book value of £913 million (2012: £893 million) has been pledged as security against borrowings.

**Qualifying asset.** An asset that necessarily requires a substantial period of time to get ready for its intended use or sale. Qualifying assets can be inventories, plant and equipment, intangibles, and investment properties, unless the assets are accounted for at fair value. Financial assets or inventories produced over a very short period of time in a repetitive process are *not* qualifying assets. Assets that are acquired and that are already in the condition for their intended use or sale are not qualifying assets.

## RECOGNITION AND MEASUREMENT

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### Capitalization of Borrowing Costs

Accounting literature says that the cost of an asset should include all the costs necessary to get the asset set up and functioning properly for its intended use in the place it is to be used. There has long been, however, a debate about whether borrowing costs should be included in the definition of all costs necessary, or whether instead such costs should be treated as purely a period expense. The concern is that two otherwise identical entities might report different asset costs simply due to decisions made regarding the financing of the entities, with the leveraged (debt issuing) entity having a higher reported asset cost. A corollary issue is whether an imputed cost of capital for equity financing should be treated as a cost to be capitalized, which would reduce or eliminate such a discrepancy in apparent asset costs.

The principal purposes to be accomplished by the capitalization of interest costs are as follows:

1. To obtain a more accurate original asset investment cost; and
2. To achieve a better matching of costs deferred to future periods with revenues of those future periods.

In the US, the FASB took the position (in FAS 34) that borrowing costs, under defined conditions, are to be added to the cost of long-lived tangible assets (and inventory also, under very limited circumstances). However, the implicit cost of equity capital may not be similarly treated as an asset cost. This treatment, where defined criteria are met, is mandatory under US GAAP. Historically, the IASB has taken a different approach, offering the US GAAP rule as one alternative treatment, optional at the reporting entity's election, until the revised IAS 23 was issued in 2007.

### *IAS 23, as revised in 2007*

In March 2007, the IASB issued the revised IAS 23, *Borrowing Costs*, which eliminated the option of recognizing borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. This revision was a result of the Short-Term Convergence project with the FASB. The revised standard provides that a reporting entity should capitalize those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the initial carrying amount of that asset, and that all other borrowing costs should be recognized as an expense in the period in which the entity incurs them.

Key changes introduced by this revised standard include:

- All borrowing costs must be capitalized if they are directly attributable to the acquisition, construction or production of a qualifying asset. The previous benchmark treatment, recognizing immediately all such financing costs as period expenses,

is eliminated. Under the new approach, which was an allowable alternative treatment in the past, all these costs must be added to the carrying amount of the assets, when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably.

- Borrowing costs that do not require capitalization relate to:
  - Assets measured at fair value (for example, a biological asset), although an entity can present items in profit or loss as if borrowing costs had been subject to capitalization, before measuring them at their fair values;
  - Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis, even if they take a substantial period of time to get ready for their intended use or sale.

Borrowing costs are defined as interest and other costs directly attributable to the acquisition, construction or production of qualifying assets (defined below). Such costs may include interest expense calculated using the effective interest rate method as described in IAS 39, finance charges related to finance leases (in accordance with IAS 17, *Leases*), and exchange differences arising from foreign currency borrowings to the extent they are treated as an adjustment to interest costs.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use and may include inventories, manufacturing plants, power generation facilities, intangible assets, properties that will become self-constructed investment properties once their construction or development is complete, and investment properties measured at cost that are being redeveloped. Other investments, and inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, as well as assets that are ready for their intended use or sale when acquired, are not qualifying assets.

Borrowing costs eligible for capitalization, directly attributable to the acquisition, construction or production of a qualifying asset, are those borrowing costs that would have been avoided if the expenditure on this asset had not been made. They include actual borrowing costs incurred less any investment income on the temporary investment of those borrowings.

The amount of borrowing costs eligible for capitalization is determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted-average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period cannot exceed the amount of borrowing costs incurred.

IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

Qualifying assets are those that normally take an extended period of time to prepare for their intended uses. While IAS 23 does not give further insight into the limitations of this definition, many years' experience with FAS 34 provided certain insights that may prove germane to this matter. In general, interest capitalization has been applied to those asset acquisition and construction situations in which:

1. Assets are being constructed for an entity's own use or for which deposit or progress payments are made;



2. Assets are produced as discrete projects that are intended for lease or sale; or
3. Investments are being made that are accounted for by the equity method, where the investee is using funds to acquire qualifying assets for its principal operations which have not yet begun.

Generally, inventories and land that are not undergoing preparation for intended use are not qualifying assets. When land is in the process of being developed, it is a qualifying asset. If land is being developed for lots, the capitalized interest cost is added to the cost of the land. The related borrowing costs are then matched against revenues when the lots are sold. If, on the other hand, the land is being developed for a building, the capitalized interest cost should instead be added to the cost of the building. The interest cost is then matched against future revenues as the building is depreciated.

The capitalization of interest costs would probably *not* apply to the following situations:

1. The routine production of inventories in large quantities on a repetitive basis;
2. For any asset acquisition or self-construction, when the effects of capitalization would not be material, compared to the effect of expensing interest;
3. When qualifying assets are already in use or ready for use;
4. When qualifying assets are not being used and are not awaiting activities to get them ready for use;
5. When qualifying assets are not included in a consolidated statement of financial position;
6. When principal operations of an investee accounted for under the equity method have already begun;
7. When regulated investees capitalize both the cost of debt and equity capital; or
8. When assets are acquired with grants and gifts restricted by the donor to the extent that funds are available from those grants and gifts.

If funds are borrowed specifically for the purpose of obtaining a qualified asset, the interest costs incurred thereon should be deemed eligible for capitalization, net of any interest earned from the temporary investment of idle funds. It is likely that there will not be a perfect match between funds borrowed and funds actually applied to the asset production process, at any given time, although in some construction projects funds are drawn from the lender's credit facility only as vendors' invoices, and other costs, are actually paid. Only the interest incurred on the project should be included as a cost of the project, however.

In other situations, a variety of credit facilities may be used to generate a pool of funds, a portion of which is applied to the asset construction or acquisition program. In those instances, the amount of interest to be capitalized will be determined by applying an average borrowing cost to the amount of funds committed to the project. Interest cost could include the following:

1. Interest on debt having explicit interest rates;
2. Interest related to finance leases; or
3. Amortization of any related discount or premium on borrowings, or of other ancillary borrowing costs such as commitment fees.

The amount of interest to be capitalized is that portion that could have been avoided if the qualifying asset had not been acquired. Thus, the capitalized amount is the incremental amount of interest cost incurred by the entity to finance the acquired asset. A weighted-average of the rates of the borrowings of the entity should be used. The selection of

borrowings to be used in the calculation of the weighted-average of rates requires judgement. In resolving this problem, particularly in the case of consolidated financial statements, the best criterion to use is the identification and determination of that portion of interest that could have been avoided if the qualifying assets had not been acquired.

The base (which should be used to multiply the weighted-average rate by) is the average amount of accumulated net capital expenditures incurred for qualifying assets during the relevant reporting period. Capitalized costs and expenditures are not synonymous terms. Theoretically, a capitalized cost financed by a trade payable for which no interest is recognized is not a capital expenditure to which the capitalization rate should be applied. Reasonable approximations of net capital expenditures are acceptable, however, and capitalized costs are generally used in place of capital expenditures unless there is a material difference.

If the average capitalized expenditures exceed the specific new borrowings for the time frame involved, the *excess* expenditures amount should be multiplied by the weighted-average of rates and not by the rate associated with the specific debt. This requirement more accurately reflects the interest cost that is actually incurred by the entity in bringing the long-lived asset to a properly functioning condition and location.

The interest being paid on the underlying debt may be either simple or subject to compounding. Simple interest is computed on the principal alone, whereas compound interest is computed on principal and on any accumulated interest that has not been paid. Compounding may be yearly, monthly or daily. Most long-lived assets will be acquired with debt having interest compounded, and that feature should be considered when computing the amount of interest to be capitalized.

The total amount of interest actually incurred by the entity during the relevant time frame is the ceiling for the amount of interest cost capitalized. Thus, the amount capitalized cannot exceed the amount actually incurred during the period. On a consolidated financial reporting basis, this ceiling is defined as the sum of the parent's interest cost plus that incurred by its consolidated subsidiaries. If financial statements are issued separately, the interest cost capitalized should be limited to the amount that the separate entity has incurred, and that amount should include interest on intercompany borrowings, which of course would be eliminated in consolidated financial statements. The interest incurred is a gross amount and is not netted against interest earned except in rare cases.

<b>Example of accounting for capitalized interest costs</b>
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Assume the following:

- On January 1, 20XX, Gemini Corp. contracted with Leo Company to construct a building for €20,000,000 on land that Gemini had purchased years earlier.
- Gemini Corp. was to make five payments in 20XX, with the last payment scheduled for the date of completion.
- The building was completed December 31, 20XX.
- Gemini Corp. made the following payments during 20XX:

January 1, 20XX	€ 2,000,000
March 31, 20XX	€ 4,000,000
June 30, 20XX	€ 6,100,000
September 30, 20XX	€ 4,400,000
December 31, 20XX	€ 3,500,000
	<u>€20,000,000</u>

- Gemini Corp. had the following debt outstanding at December 31, 20XX:

- A 12%, 4-year note dated 1/1/20XX-3 with interest compounded quarterly. Both principal and interest due 12/31/20XX+1 (relates specifically to building project) €8,500,000
- A 10%, 10-year note dated 13/31/20XX-8 with simple interest and interest payable annually on December 31 €6,000,000
- A 12%, 5-year note dated 13/31/20XX-6 with simple interest and interest payable annually on December 31 €7,000,000

The amount of interest to be capitalized during 20XX is computed as follows:

*Average Accumulated Expenditures*

<u>Date</u>	<u>Expenditure</u>	<u>Capitalization period*</u>	<u>Average accumulated expenditures</u>
1/1/20XX	€ 2,000,000	12/12	€2,000,000
3/31/20XX	€ 4,000,000	9/12	€3,000,000
6/30/20XX	€ 6,100,000	6/12	€3,050,000
9/30/20XX	€ 4,400,000	3/12	€1,100,000
12/31/20XX	€ 3,500,000	0/12	--
	<u>€20,000,000</u>		<u>€9,150,000</u>

\*The number of months between the date when expenditures were made and the date on which interest capitalization stops (December 31, 20XX).

*Potential Interest Cost to Be Capitalized*

$$\begin{aligned}
 &(\text{€}8,500,000 \times 1.12551)^* - \text{€}8,500,000 = \text{€}1,066,840 \\
 &\quad \quad \quad \text{€}650,000 \times 0.1109^{**} \quad \quad \quad = \quad \quad \quad \underline{\text{€}72,020} \\
 &\underline{\text{€}9,150,000} \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \quad \underline{\text{€}1,138,860}
 \end{aligned}$$

\*The principal, €8,500,000, is multiplied by the factor for the future amount of €1 for 4 periods at 3% to determine the amount of principal and interest due in 20XX.

\*\*Weighted-average interest rate.

	<u>Principal</u>	<u>Interest</u>
10%, 10-year note	€ 6,000,000	€ 600,000
12%, 5-year note	€ 7,000,000	€ 840,000
	<u>€ 13,000,000</u>	<u>€1,440,000</u>
	<u>Total interest = €1,440,000</u>	
	<u>Total principal = €13,000,000 = 11.08%</u>	

The actual interest is

12%, 4-year note [(€8,500,000 × 1.12551) – €8,500,000]	= €1,066,840
10%, 10-year note (€6,000,000 × 10%)	= € 600,000
12%, 5-year note (€7,000,000 × 12%)	= € 840,000
Total interest	€2,506,840

The interest cost to be capitalized is the lesser of €1,138,860 (avoidable interest) or €2,506,840 (actual interest). The remaining €1,367,980 (= €2,506,840 – €1,138,860) must be expensed.

### ***Determining the time period for capitalization of borrowing costs***

An entity should begin capitalizing borrowing costs on the commencement date. Three conditions must be met before the capitalization period should begin:

1. Expenditures for the asset are being incurred;
2. Borrowing costs are being incurred; and
3. Activities that are necessary to prepare the asset for its intended use are in progress.

As long as these conditions continue, borrowing costs can be capitalized. Expenditures incurred for the asset include only those that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities, and are reduced by any progress payments and grants received for that asset.

Necessary activities are interpreted in a very broad manner. They start with the planning process and continue until the qualifying asset is substantially complete and ready to function as intended. These activities may include technical and administrative work prior to actual commencement of physical work, such as obtaining permits and approvals, and may continue after physical work has ceased. Brief, normal interruptions do not stop the capitalization of interest costs. However, if the entity intentionally suspends or delays the activities for some reason, interest costs should not be capitalized from the point of suspension or delay until substantial activities in regard to the asset resume.

If the asset is completed in a piecemeal fashion, the capitalization of interest costs stops for each part as it becomes ready to function as intended. An asset that must be entirely complete before the parts can be used as intended can continue to capitalize interest costs until the total asset becomes ready to function.

### ***Suspension and cessation of capitalization***

If there is an extended period during which there is no activity to prepare the asset for its intended use, capitalization of borrowing costs should be suspended. As a practical matter, unless the break in activity is significant, it is usually ignored. Also, if delays are normal and to be expected given the nature of the construction project (such as a suspension of building

construction during the winter months), this would have been anticipated as a cost and would not warrant even a temporary cessation of borrowing cost capitalization.

Capitalization would cease when the project has been substantially completed. This would occur when the asset is ready for its intended use or for sale to a customer. The fact that routine minor administrative matters still need to be attended to would not mean that the project had not been completed, however. The measure should be *substantially* complete, in other words, not absolutely finished.

### ***Costs in excess of recoverable amounts***

When the carrying amount or the expected ultimate cost of the qualifying asset, including capitalized interest cost, exceeds its recoverable amount (if property, plant or equipment) or net realizable value (if an item held for resale), it will be necessary to record an adjustment necessary to write the asset carrying amount down. Any excess interest cost is thus an impairment, to be recognized immediately in expense.

In the case of plant, property and equipment, a later write-up may occur due to use of the allowed alternative (i.e., revaluation) treatment, recognizing fair value increases, in which case, as described earlier, recovery of a previously recognized loss will be reported in earnings.

### ***Disclosure requirements***

With respect to an entity's accounting for borrowing costs, the financial statements must disclose:

1. The amount of borrowing costs capitalized during the period; and
2. The capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

As noted, this rate will be the weighted-average of rates on all borrowings included in an allocation pool or the actual rate on specific debt identified with a given asset acquisition or construction project.

## **US GAAP COMPARISON**

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US GAAP and IFRS are nearly identical with regard to capitalized interest. Both have essentially the same definition of eligible assets, when the capitalization can begin, and when it ends. However, there are also some differences regarding what borrowings are included to compute a capitalization rate, and costs do not include exchange rate differences. US GAAP does not require that all borrowings be included in the determination of the weighted-average capitalization rate. Only a reasonable measure of cost for financing the acquisition must be capitalized. A reasonable interest cost is the interest incurred that otherwise would have been avoided if not for constructing the eligible asset. With the exception of tax-exempt borrowings, US GAAP does not permit offsetting of interest income against interest expense to determine the amount to capitalize. The interest income can only be that which was earned on the tax-exempt borrowing. US GAAP does not permit capitalization of interest for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis (ASC 835-20-15-6[g]).

As an example:

The Dell brand does not appear on Dell's statement of financial position, nor does the Nestle brand appear on Nestlé's statement of financial position. Exceptions to this are constructions where brand names are being transferred within large corporate clients outside the group structure, and consequently will be recognized and recorded as long-lived assets. In these situations it is particularly important to determine whether the long-lived assets are internally generated or not.

Concepts, designs, sales networks, brands and processes are all important elements of what enables one company to succeed while another fails, but the theoretical support for representing them on the statement of financial position is at an early stage of development. For that matter, few companies even attempt to monitor such values for internal management purposes, so it is hardly surprising that the external reporting is still evolving.

We can draw a distinction between internally generated intangibles which are difficult to measure and thus to recognize in the statement of financial position, such as research and development assets and brands, and those that are purchased externally by an entity and therefore have a purchase price. While an intangible can certainly be bought individually, most intangibles arise from acquisitions of other companies, where a bundle of assets and liabilities are acquired.

In this area of activity, we can further distinguish between identifiable intangibles and unidentifiable ones.

**Identifiable intangibles** include patents, copyrights, brand names, customer lists, trade names and other specific rights that typically can be conveyed by an owner without necessarily also transferring related physical assets. Goodwill, on the other hand, is a residual which incorporates all the intangibles that cannot be reliably measured separately, and is often analysed as containing both these and benefits that the acquiring entity expected to gain from the synergies or other efficiencies arising from a business combination and cannot normally be transferred to a new owner without also selling the other assets and/or the operations of the business.

Accounting for goodwill is addressed in IFRS 3, and is discussed in Chapter 15 in this publication, in the context of business combinations. In this chapter we will address the recognition and measurement criteria for identifiable intangibles. This includes the criteria for separability and treatment of internally generated intangibles, such as research and development costs.

The subsequent measurement of intangibles depends upon whether they are considered to have indefinite economic value or a finite useful life. The standard on impairment of assets (IAS 36) pertains to both tangible and intangible long-lived assets. This chapter will consider the implications of this standard for the accounting for intangible, separately identifiable assets.

<i>IFRS 3</i>	<b>Sources of IFRS</b> <i>IAS 23, 36, 38</i>	SIC 32
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## SCOPE

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IAS 38 applies to all reporting entities. It prescribes the accounting treatment for intangible assets, including development costs, but does not address intangible assets covered by other IFRS. For instance, deferred tax assets are covered under IAS 12; leases fall within the scope of IAS 17; goodwill arising in a business combination is dealt with by

IFRS 3; assets arising from employee benefits are covered by IAS 19; and financial assets are defined by IAS 32 and covered by IFRS 10, 11, IAS 28, and 39. IAS 38 also does not apply to intangible assets arising in insurance companies from contracts with policyholders within the scope of IFRS 4, nor to exploration and evaluation assets in the extractive industries subject to IFRS 6, nor to intangible assets classified as held-for-sale under IFRS 5.

## DEFINITIONS OF TERMS

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**Active market.** A market in which all the following conditions exist:

1. The items traded in the market are homogeneous;
2. Willing buyers and sellers can normally be found at any time; and
3. Prices are available to the public.

**Amortization.** Systematic allocation of the depreciable amount of an intangible asset on a systematic basis over its useful life.

**Asset.** A resource that is:

1. Controlled by an entity as a result of past events; and
2. From which future economic benefits are expected to flow to the entity.

**Carrying amount.** The amount at which an asset is recognized in the statement of financial position, net of any accumulated amortization and accumulated impairment losses thereon.

**Cash-generating unit.** The smallest identifiable group of assets that generates cash inflows from continuing use, largely independent of the cash inflows associated with other assets or groups of assets.

**Corporate assets.** Assets, excluding goodwill, that contribute to future cash flows of both the cash-generating unit under review for impairment and other cash generating units.

**Cost.** Amount of cash or cash equivalent paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRS (e.g., IFRS 2, *Share-Based Payment*).

**Depreciable amount.** Cost of an asset or the other amount that has been substituted for cost, less the residual value of the asset.

**Development.** The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to commencement of commercial production or use. This should be distinguished from *research*, which must be expensed whereas development costs are capitalized.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Goodwill.** An intangible asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

**Impairment loss.** The excess of the carrying amount of an asset over its recoverable amount.

**Intangible assets.** Identifiable non-monetary assets without physical substance.

**Monetary assets.** Money held and assets to be received in fixed or determinable amounts of money. Examples are cash, accounts receivable, and notes receivable.

**Net selling price.** The amount that could be realized from the sale of an asset by means of an arm's-length transaction, less costs of disposal.

**Non-monetary transactions.** Exchanges and non-reciprocal transfers that involve little or no monetary assets or liabilities.

**Non-reciprocal transfer.** Transfer of assets or services in one direction, either from an entity to its owners or another entity, or from owners or another entity to the entity. An entity's reacquisition of its outstanding stock is a non-reciprocal transfer.

**Recoverable amount.** The greater of an asset's or a cash-generating unit's fair value less costs to sell and its value in use.

**Research.** The original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. This should be distinguished from *development*, since the latter is capitalized whereas research costs must be expensed.

**Residual value.** Estimated amount that an entity would currently obtain from disposal of the asset, net of estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Useful life.** Period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity.

**Value in use.** Present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life.

## RECOGNITION AND MEASUREMENT

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### Background

Over the years, the role of intangible assets has grown ever more important for the operations and prosperity of many types of businesses, as the "knowledge-based" economy becomes more dominant.

IFRS first addressed accounting for intangibles in a thorough way with IAS 38, which was promulgated in 1998. Research and development costs had earlier been addressed by IAS 9 (issued in 1978) and goodwill arising from a business combination was dealt with by IAS 22 (issued in 1983).

IAS 38 is the first comprehensive standard on intangibles and it superseded IAS 9. It established recognition criteria, measurement bases, and disclosure requirements for intangible assets. The standard also stipulates that impairment testing for intangible assets (as specified by IAS 36) is to be undertaken on a regular basis. This is to ensure that only assets having *recoverable values* will be capitalized and carried forward to future periods as assets of the business.

IAS 38 was modified in 2004 to acknowledge that intangible assets could have indefinite useful lives. It had been the intent, when developing IAS 38, to stipulate that intangibles should have a maximum life of 20 years, but when this standard was finally approved, it included a rebuttable presumption that an intangible would have a life of no more than 20 years. The most recent amendment to IAS 38 removed the rebuttable presumption as to maximum economic life. IAS 38 now includes a list of intangibles that should normally be given separate recognition, and not merely grouped with goodwill, which is to denote only the unidentified intangible asset acquired in a business combination.

The IASB have identified intangibles as one of their current research projects.



## Nature of Intangible Assets

Identifiable intangible assets include patents, copyrights, licenses, customer lists, brand names, import quotas, computer software, marketing rights and specialized know-how. These items have in common the fact that there is little or no tangible substance to them, and they have a useful life of greater than one year. In many but not all cases, the asset is separable; that is, it could be sold or otherwise disposed of without simultaneously disposing of or diminishing the value of other assets held.

Intangible assets are, by definition, assets that have no physical substance. However, there may be instances where intangibles also have some physical form. For example:

- There may be tangible evidence of an asset's existence, such as a certificate indicating that a patent had been granted, but this does not constitute the asset itself;
- Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software); and
- Identifiable assets that result from research and development activities are intangible assets because the tangible prototype or model is secondary to the knowledge that is the primary outcome of those activities.

In the case of assets that have both tangible and intangible elements, there may be uncertainty about whether classification should be as tangible or intangible assets. For example, the IASB has deliberately not specified whether mineral exploration and evaluation assets should be considered as tangible or intangible, but rather, in IFRS 6 (see Chapter 32) has established a requirement that a reporting entity consistently account for exploration and evaluation assets as either tangible or intangible.

As a rule of thumb, an asset that has both tangible and intangible elements should be classified as an intangible asset or a tangible asset based on the relative dominance or comparative significance of the tangible or the intangible components of the asset. For instance, computer software that is not an integral part of the related hardware equipment is treated as software (i.e., as an intangible asset). Conversely, certain computer software, such as the operating system, that is essential and an integral part of a computer, is treated as part of the hardware equipment (i.e., as property, plant and equipment as opposed to an intangible asset).

## Recognition Criteria

Identifiable intangible assets have much in common with tangible long-lived assets (property, plant and equipment), and the accounting for them is accordingly very similar. Recognition depends on whether the *Framework* definition of an asset is satisfied. The key criteria for determining whether intangible assets are to be recognized are:

1. Whether the intangible asset can be identified separately from other aspects of the business entity;
2. Whether the use of the intangible asset is controlled by the entity as a result of its past actions and events;
3. Whether future economic benefits can be expected to flow to the entity; and
4. Whether the cost of the asset can be measured reliably.

### **Identifiability**

IAS 38 states that an intangible meets the identifiability requirement if:

1. It 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*
2. It 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.

The nature of intangibles is such that, as discussed above, many are not recognized at the time that they come into being. The costs of creating many intangibles are typically expensed year by year (e.g., as research costs or other period expenses) before it is clear that an asset has been created. The cost of internal intangible asset development cannot be capitalized retrospectively, and this means that such assets remain off the statement of financial position until and unless the entity is acquired by another entity. The acquiring entity has to allocate the acquisition price over the bundle of assets and liabilities acquired, irrespective of whether those assets and liabilities had been recognized in the acquired company's statement of financial position. For that reason, the notion of identifiability is significant in enabling an allocation of the cost of a business combination to be made.

The IASB prefers that as many individual assets be recognized as possible in a business acquisition, because the residual amount of unallocated acquisition cost is treated as goodwill, which provides less transparency to investors and other financial statement users. Furthermore, since goodwill is no longer subject to amortization, and its continued recognition—withstanding the impairment testing provision—can be indirectly justified by the creation of internally generated goodwill, improperly combining identifiable intangibles with goodwill can have long-term effects on the representational faithfulness of the entity's financial statements.

The revised IFRS 3, *Business Combinations*, issued in January 2008, introduced new approaches to measuring and recognizing the assets acquired and the liabilities assumed in business combinations. The standard reinforces the presumption that the acquirer should recognize, separately from goodwill, the acquisition-date fair value of an intangible asset acquired in a business combination if it meets the criteria provided in revised IAS 38. (This matter is discussed in detail in Chapter 15.)

Inasmuch as the IASB advocates the recognition of the individual assets that may have been acquired in a business combination, it did acknowledge in the 2009 Improvements Project the difficulty that reporters may face in separating the intangible assets acquired. In this regard, the standard was amended to take into account that an intangible asset acquired in a business combination might be separable, but only together with a related contract or liability. In such cases, the acquirer recognizes the intangible asset separately from goodwill but together with the related item. The acquirer may recognize a group of complementary intangible assets as a single asset provided the individual assets in the group have similar useful lives. For example, the terms “brand” and “brand name” are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.

### **Control**

The provisions of IAS 38 require that an entity should be in a position to control the use of any intangible asset that is to be presented in the entity's statement of financial position.

Control implies the power to both obtain future economic benefits from the asset as well as restrict others' access to those benefits. Normally, entities register patents, copyrights, etc. to ensure control over these intangible assets, although entities often have to engage in litigation to preserve that control.

A patent provides the registered owner (or licensee) the exclusive right to use the underlying product or process without any interference or infringement from others. In contrast with these, intangible assets arising from technical knowledge of staff, customer loyalty, long-term training benefits, etc., will have difficulty meeting this recognition criteria in spite of expected future economic benefits to be derived from them. This is due to the fact that the entity would find it impossible to fully control these resources or to prevent others from controlling them.

For instance, even if an entity expends considerable resources on training that will supposedly increase staff skills, the economic benefits from skilled staff cannot be controlled, since trained employees could leave their current employment and move on in their career to other employers. Hence, staff training expenditures, no matter how material in amount, do not qualify as an intangible asset.

### ***Future economic benefits***

Generally an asset is recognized only if it is *probable* that future economic benefits specifically associated therewith will flow to the reporting entity, and the cost of the asset can be *measured reliably*. Traditionally, the probability issue acts as an on-off switch. If the future cash flow is *more likely than not* to occur, the item is recognized, but if the cash flow is less likely to occur, nothing is recognized. However, under IFRS 3, where an intangible asset is acquired as part of a business combination, it is valued at fair value, and the fair value computation is affected by the probability that the future cash flow will occur. Under the fair value approach the recorded amount is determined as the present value of the cash flow, adjusted for the likelihood of receiving it, as well as for the time value of money. Under IFRS 3 the probability criteria are always considered satisfied for intangible assets that are acquired separately or in a business combination.

The future economic benefits envisaged by the standard may take the form of revenue from the sale of products or services, cost savings or other benefits resulting from the use of the intangible asset by the entity. A good example of other benefits resulting from the use of the intangible asset is the use by an entity of a secret formula (which the entity has protected legally) that leads to reduced levels of competition in the marketplace, thus enhancing the prospects for substantial and profitable future sales and reduced expenditures on such matters as product development and advertising.

### **Measurement of the Cost of Intangibles**

The conditions under which the intangible asset has been acquired will determine the measurement of its cost.

The cost of an intangible asset acquired separately is determined in a manner largely analogous to that for tangible long-lived assets as described in Chapter 9. Thus, the cost of a separately acquired intangible asset includes:

1. Its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

2. Any directly attributable costs incurred to prepare the asset for its intended use. Directly attributable costs would include costs of employee benefits or costs of employee benefits arising directly from bringing the asset to its intended use, and professional fees incurred in bringing the asset to its working condition, costs of testing whether the asset is functioning properly.

As with tangible assets, capitalization of costs ceases at the point when the intangible asset is ready to be placed in service in the manner intended by management. Any costs incurred in using or redeploying intangible assets are accordingly excluded from the cost of those assets. Thus, any costs incurred while the asset is capable of being used in the manner intended by management, but while it has yet to be placed into service, would be expensed, not capitalized. Similarly, initial operating losses, such as those incurred while demand for the asset's productive outputs is being developed, cannot be capitalized. Examples of expenditures that are not part of the cost of an intangible asset include costs of introducing a new product or service, costs of conducting business in a new location or with a new class of customers, and administration and other general overhead costs. On the other hand, further costs incurred for the purpose of improving the asset's level of performance would qualify for capitalization. In all these particulars, guidance under IAS 38 mirrors that under IAS 16.

According to IAS 38, the cost of an intangible asset acquired as part of a business combination is its fair value as at the date of acquisition. If the intangible asset is separable or arises from contractual or other legal rights sufficient information exists to measure reliably the fair value of the asset. If the intangible asset has no active market, then fair value is determined based on the amount that the entity would have paid for the asset in an arm's-length transaction at the date of acquisition. If the fair value of an intangible asset acquired as part of a business combination cannot be measured reliably, then that asset is not separately recognized, but rather, is included in goodwill. This fallback position is to be used only when direct identification of the intangible asset's value cannot be accomplished.

If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as financing cost over the period of credit unless it is capitalized in accordance with IAS 23 (See Chapter 10).

### ***Intangibles acquired through an exchange of assets***

In other situations, intangible assets may be acquired in exchange or partly *in exchange for other dissimilar intangible* or other assets. The same *commercial substance* rules under IAS 16 apply under IAS 38. If the exchange will affect the future cash flows of the entity, then it has commercial substance, and the acquired asset is recognized at its fair value, and the asset given up is also measured at fair value. Any difference between carrying amount of the asset(s) given up and those acquired will be given recognition as a gain or loss. However, if there is no commercial substance to the exchange, or the fair values cannot be measured reliably, then the value used is that of the asset given up.

**Internally generated goodwill** is not recognized as an intangible asset because it fails to meet recognition criteria including:

- Reliable measurement of cost;
- An identity separate from other resources; and
- Control by the reporting entity.

In practice, accountants are often confronted with the reporting entity's desire to recognize internally generated goodwill based on the premise that at a certain point in time the market value of an entity exceeds the carrying amount of its identifiable net assets. However, IAS 38 categorically states that such differences cannot be considered to represent the cost of intangible assets *controlled by the entity*, and hence could not meet the criteria for recognition (i.e., capitalization) of such an asset in the accounts of the entity. Nonetheless, standard setters are concerned that when an entity tests a cash-generating unit for impairment, internally generated goodwill cannot be separated from acquired goodwill, and that it forms a cushion against impairment of acquired goodwill. In other words, when an entity has properly recognized goodwill (i.e., that acquired in a business combination), implicitly there is the likelihood that internally generated goodwill may well achieve recognition in later periods, to the extent that this offsets the impairment of goodwill.

### ***Intangibles acquired at little or no cost by means of government grants***

If the intangible is acquired without cost or by payment of nominal consideration, as by means of a government grant (e.g., when the government grants the right to operate a radio station) or similar means, and assuming the historical cost treatment is being utilized to account for these assets, obviously there will be little or no amount reflected as an asset. If the asset is important to the reporting entity's operations, however, it must be adequately disclosed in the notes to the financial statements.

If the revaluation method of accounting for the asset is used, as permitted under IAS 38, the fair value should be determined by reference to an active market. However, given the probable lack of an active market, since government grants are virtually never transferable, it is unlikely that this situation will be encountered. If an active market does not exist for this type of an intangible asset, the entity must recognize the asset at cost. Cost would include those that are directly attributable to preparing the asset for its intended use. Government grants are addressed in Chapter 21.

### **Internally Generated Intangibles other than Goodwill**

In many instances, intangibles are generated internally by an entity, rather than being acquired via a business combination or some other acquisitions. Because of the nature of intangibles, the measurement of the cost (i.e., the initial amounts at which these could be recognized as assets) is constrained by the fact that many of the costs have already been expensed by the time the entity is able to determine that an asset has indeed been created. For example, when launching a new magazine, an entity may have to operate the magazine at a loss in its early years, expensing large promotional and other costs which all flow through the income statement before such time as the magazine can be determined to have become established, and have branding that might be taken to represent an intangible asset. At the point the brand is determined to be an asset, all the costs of creating it have already been expensed, and no retrospective adjustment is allowed to create a recognized asset.

IAS 38 provides that internally generated intangible assets are to be capitalized and amortized over the projected period of economic utility, provided that certain criteria are met.

Expenditures pertaining to the creation of intangible assets are to be classified alternatively as being indicative of, or analogous to, either research activity or development activity. Per IAS 38:

1. Costs incurred in the *research* phase are expensed immediately; and
2. If costs incurred in the *development* phase meet the recognition criteria for an intangible asset, such costs should be capitalized. However, once costs have been expensed during the development phase, they cannot later be capitalized.

In practice, distinguishing research-like expenditures from development-like expenditures might not be easily accomplished. This would be especially true in the case of intangibles for which the measurement of economic benefits cannot be accomplished in anything approximating a direct manner. Assets such as brand names, mastheads and customer lists can prove quite resistant to such direct observation of value (although in many industries there are rules of thumb, such as the notion that a customer list in the securities brokerage business is worth \$1,500 per name, implying the amount of promotional costs a purchaser of a customer list could avoid incurring itself).

Thus, entities may incur certain expenditures in order to enhance brand names, such as engaging in image-advertising campaigns, but these costs will also have ancillary benefits, such as promoting specific products that are being sold currently, and possibly even enhancing employee morale and performance. While it may be argued that the expenditures create or add to an intangible asset, as a practical matter it would be difficult to determine what portion of the expenditures relate to which achievement, and to ascertain how much, if any, of the cost may be capitalized as part of brand names. Thus, it is considered to be unlikely that threshold criteria for recognition can be met in such a case. For this reason IAS 38 has specifically disallowed the capitalization of internally generated assets like brands, mastheads, publishing titles, customer lists and items similar in substance to these.

Apart from the prohibited items, however, IAS 38 permits recognition of internally created intangible assets to the extent the expenditures can be analogized to the development phase of a research and development program. Thus, internally developed patents, copyrights, trademarks, franchises and other assets will be recognized at the cost of creation, exclusive of costs which would be analogous to research, as further explained in the following paragraphs. The Basis for Conclusions to IAS 38 notes that “some view these requirements and guidance as being too restrictive and arbitrary” and that they reflect the standard setter’s interpretation of the recognition criteria, but it agrees that they reflect the fact that it is difficult in practice to determine whether there is an internally generated asset separate from internally generated goodwill.

When an internally generated intangible asset meets the recognition criteria, the cost is determined using the same principles as for an acquired tangible asset. Thus, cost comprises all costs directly attributable to creating, producing and preparing the asset for its intended use. IAS 38 closely mirrors IAS 16 with regard to elements of cost that may be considered as part of the asset, and the need to recognize the cash equivalent price when the acquisition transaction provides for deferred payment terms. As with self-constructed tangible assets, elements of profit must be eliminated from amounts capitalized, but incremental administrative and other overhead costs can be allocated to the intangible and included in the asset’s cost provided these can be directly attributed to preparing the asset for use. Initial operating

losses, on the other hand, cannot be deferred by being added to the cost of the intangible, but rather must be expensed as incurred.

The standard takes this view based on the premise that an entity cannot demonstrate that the expenditure incurred in the research phase will generate probable future economic benefits, and consequently, that an intangible asset has been created (therefore, such expenditure should be expensed). Examples of research activities include: activities aimed at obtaining new knowledge; the search for, evaluation and final selection of applications of research findings; and the search for and formulation of alternatives for new and improved systems, etc.

The standard recognizes that the development stage is further advanced towards ultimate commercial exploitation of the product or service being created than is the research stage. It acknowledges that an entity can possibly, in certain cases, identify an intangible asset and demonstrate that this asset will probably generate future economic benefits for the organization. Accordingly, IAS 38 allows recognition of an intangible asset during the development phase, provided the entity can demonstrate all of the following:

- 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 either use it or sell it;
- Its ability to use or sell the intangible asset;
- The mechanism by which the intangible 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
- The entity's ability to reliably measure the expenditure attributable to the intangible asset during its development.

Examples of development activities include: the design and testing of preproduction proto-types or models; design of tools, jigs, molds and dies including new technology; design, construction and operation of a pilot plant which is not otherwise commercially feasible; design and testing of a preferred alternative for new and improved devices, products, processes, systems or services.

### ***Recognition of internally generated computer software costs***

The recognition of computer software costs poses several questions.

1. In the case of a company developing software programs for sale, should the costs incurred in developing the software be expensed, or should the costs be capitalized and amortized?
2. Is the treatment for developing software programs different if the program is to be used for in-house applications only?
3. In the case of purchased software, should the cost of the software be capitalized as a tangible asset or as an intangible asset, or should it be expensed fully and immediately?

In view of IAS 38's provisions the position can be clarified as follows:

1. In the case of a software-developing company, the costs incurred in the development of software programs are research and development costs. Accordingly, all expenses

incurred in the research phase would be expensed. That is, all expenses incurred before *technological feasibility* for the product has been established should be expensed. The reporting entity would have to demonstrate both technological feasibility and a probability of its commercial success. Technological feasibility would be established if the entity has completed a detailed program design or working model. The entity should have completed the planning, designing, coding and testing activities and established that the product can be successfully produced. Apart from being capable of production, the entity should demonstrate that it has the intention and ability to use or sell the program. Action taken to obtain control over the program in the form of copyrights or patents would support capitalization of these costs. At this stage the software program would be able to meet the criteria of identifiability, control and future economic benefits, and can thus be capitalized and amortized as an intangible asset.

2. In the case of software internally developed for in-house use—for example, a computerized payroll program developed by the reporting entity itself—the accounting approach would be different. While the program developed may have some utility to the entity itself, it would be difficult to demonstrate how the program would generate future economic benefits to the entity. Also, in the absence of any legal rights to control the program or to prevent others from using it, the recognition criteria would not be met. Further, the cost proposed to be capitalized should be recoverable. In view of the impairment test prescribed by the standard, the carrying amount of the asset may not be recoverable and would accordingly have to be adjusted. Considering the above facts, such costs may need to be expensed.
3. In the case of purchased software, the treatment could differ and would need to be evaluated on a case-by-case basis. Software purchased for sale would be treated as inventory. However, software held for licensing or rental to others should be recognized as an intangible asset. On the other hand, cost of software purchased by an entity for its own use and which is integral to the hardware (because without that software the equipment cannot operate), would be treated as part of cost of the hardware and capitalized as property, plant and equipment. Thus, the cost of an operating system purchased for an in-house computer, or cost of software purchased for computer-controlled machine tool, is treated as part of the related hardware.

The costs of other software programs should be treated as intangible assets (as opposed to being capitalized along with the related hardware), as they are not an integral part of the hardware. For example, the cost of payroll or inventory software (purchased) may be treated as an intangible asset provided it meets the capitalization criteria under IAS 38. In practice, the conservative approach would be to expense such costs as they are incurred, since their ability to generate future economic benefits will always be questionable. If the costs are capitalized, useful lives should be conservatively estimated (i.e., kept brief) because of the well-known risk of technological obsolescence.

#### Example of software developed for internal use

The Hy-Tech Services Corporation employs researchers based in countries around the world. Employee time is the basis upon which charges to many customers are made. The geographically dispersed nature of its operations makes it extremely difficult for the payroll staff to collect time



records, so the management team authorizes the design of an in-house, web-based timekeeping system. The project team incurs the following costs:

<u>Cost type</u>	<u>Charged to expense</u>	<u>Capitalized</u>
Concept design	€ 2,500	
Evaluation of design alternatives	3,700	
Determination of required technology	8,100	
Final selection of alternatives	1,400	
Software design		€ 28,000
Software coding		42,000
Quality assurance testing		30,000
Data conversion costs	3,900	
Training	14,000	
Overhead allocation	6,900	
General and administrative costs	11,200	
Ongoing maintenance costs	<u>6,000</u>	
Totals	<u>€57,700</u>	<u>€100,000</u>

Thus, the total capitalized cost of this development project is €100,000. The estimated useful life of the timekeeping system is five years. As soon as all testing is completed, Hy-Tech's controller begins amortizing using a monthly charge of €1,666.67. The calculation is as follows:

$$€100,000 \text{ capitalized cost} \div 60 \text{ months} = €1,666.67 \text{ amortization charge}$$

Once operational, management elects to construct another module for the system that issues an e-mail reminder for employees to complete their timesheets. This represents significant added functionality, so the design cost can be capitalized. The following costs are incurred:

<u>Labour type</u>	<u>Labour cost</u>	<u>Payroll taxes</u>	<u>Benefits</u>	<u>Total cost</u>
Software developers	€11,000	€ 842	€1,870	€13,712
Quality assurance testers	<u>7,000</u>	<u>536</u>	<u>1,190</u>	<u>8,726</u>
Totals	<u>€18,000</u>	<u>€1,378</u>	<u>€3,060</u>	<u>€22,438</u>

The full €22,438 amount of these costs can be capitalized. By the time this additional work is completed, the original system has been in operation for one year, thereby reducing the amortization period for the new module to four years. The calculation of the monthly straight-line amortization follows:

$$€22,438 \text{ capitalized cost} \div 48 \text{ months} = €467.46 \text{ amortization charge}$$

The Hy-Tech management then authorizes the development of an additional module that allows employees to enter time data into the system from their cell phones using text messaging. Despite successfully passing through the concept design stage, the development team cannot resolve interface problems on a timely basis. Management elects to shut down the development project, requiring all of the €13,000 of programming and testing costs to be expensed in the current period.

### Costs Not Satisfying the IAS 38 Recognition Criteria

The standard has specifically provided that expenditures incurred for non-financial intangible assets should be recognized as an expense unless:

1. It relates to an intangible asset dealt with in another IFRS;
2. The cost forms part of the cost of an intangible asset that meets the recognition criteria prescribed by IAS 38; or

3. It is acquired in a business combination and cannot be recognized as an identifiable intangible asset. In this case, this expenditure should form part of the amount attributable to goodwill as at the date of acquisition.

As a consequence of applying the above criteria, the following costs are expensed as they are incurred:

- Research costs;
- Preopening costs for a new facility or business, and plant start-up costs incurred during a period prior to full-scale production or operation, unless these costs are capitalized as part of the cost of an item of property, plant and equipment;
- Organization costs such as legal and secretarial costs, which are typically incurred in establishing a legal entity;
- Training costs involved in operating a business or a product line;
- Advertising and related costs;
- Relocation, restructuring and other costs involved in organizing a business or product line;
- Customer lists, brands, mastheads and publishing titles that are internally generated.

In some countries entities have previously been allowed to defer and amortize set-up costs and pre-operating costs on the premise that benefits from them flow to the entity over future periods as well. IAS 38 does not condone this view.

The criteria for recognition of intangible assets as provided in IAS 38 are rather stringent, and many entities will find that expenditures either to acquire or to develop intangible assets will fail the test for capitalization. In such instances, all these costs must be expensed as period costs when incurred. Furthermore, once expensed, these costs cannot be resurrected and capitalized in a later period, even if the conditions for such treatment are later met. This is not meant, however, to preclude correction of an error made in an earlier period if the conditions for capitalization were met but interpreted incorrectly by the reporting entity at that time.

#### **Example of development cost capitalization**

Assume that Creative Incorporated incurs substantial research and development costs for the invention of new products, many of which are brought to market successfully. In particular, Creative has incurred costs during 20XX amounting to €750,000, relative to a new manufacturing process. Of these costs, €600,000 was incurred prior to December 1, 20XX. As of December 31, the viability of the new process was still not known, although testing had been conducted on December 1. In fact, results were not conclusively known until February 15, 20XX+1, after another €75,000 in costs was incurred post-January 1. Creative Incorporated's financial statements for 20XX were issued February 10, 20XX+1, and the full €750,000 in research and development costs was expensed, since it was not yet known whether a portion of these qualified as development costs under IAS 38. When it is learned that feasibility had, in fact, been shown as of December 1, Creative's management asks to restore the €150,000 of post-December 1 costs as a development asset. Under IAS 38 this is prohibited. However, the 20XX+1 costs (€75,000 thus far) would qualify for capitalization, in all likelihood, based on the facts known.

Improvements to IFRS published by the IASB in May 2008 included two amendments to IAS 38. One improvement clarifies that certain expenditures are recognized as an expense

when the entity either has access to the goods or has received the services. Examples of expenditures that are recognized as an expense when incurred include research costs, expenditure on start-up activities, training activities, advertising and promotional activities, and on relocating or reorganizing part or all of an entity. Advertising and promotional activities now specifically include mail-order catalogues. Logically, these expenditures have difficult-to-measure future economic benefits (e.g., advertising), or are not controlled by the reporting entity (e.g., training), and therefore do not meet the threshold conditions for recognition as assets. For some entities this amendment may result in expenditures being recognized as an expense earlier than in the past.

In addition, a second improvement to IAS 38 removed the reference to the use of anything other than the straight-line method of amortization being rare, and makes it clear that entities may use the unit of production method of amortization even if it results in a lower amount of accumulated amortization than does the straight-line method. This would specifically apply to some service concession arrangements, where an intangible asset for the right to charge users for public service is created. Consequently, entities will have more flexibility as to the method of amortization of intangible assets and will need to evaluate a pattern of future benefits arising from those assets when selecting the method.

Improvements to IFRS made in 2009 included several clarifying revisions to IAS 38. One group of wording changes was made to reflect clearly the IASB's decisions on the accounting for intangible assets acquired in a business combination, as set forth by the revised IFRS 3 (discussed in Chapter 15), which was also briefly mentioned earlier in this chapter.

The other changes were to clarify the description of valuation techniques commonly used to measure intangible assets at fair value when assets are not traded in an active market. The IASB also decided that these amendments should be applied prospectively, notwithstanding the general retrospective prescription under IAS 8, because retrospective application might require some entities to remeasure fair values associated with previous transactions, a process that inadvertently could involve the use of hindsight in those circumstances. This guidance has since been rendered obsolete and deleted as a consequence of the issuance of IFRS 13 (see Chapter 25).

### **Subsequently Incurred Costs**

Under the provisions of IAS 38, the capitalization of any subsequent costs incurred on recognized intangible assets are subject to the same recognition criteria as initial costs. In practice, capitalization of subsequent expenditure is often difficult to justify. This is because the nature of an intangible asset is such that, in many cases, it is not possible to determine whether subsequent costs are likely to enhance the specific economic benefits that will flow to the entity from those assets. Provided they meet the recognition criteria for intangible assets, any subsequent expenditure on an intangible after its purchase or its completion should be capitalized along with its cost. The following example should help to illustrate this point better.

#### **Example of subsequent costs**

An entity is developing a new product. Costs incurred by the R&D department in 20XX-1 on the "research phase" amounted to €200,000. In 20XX, technical and commercial feasibility of the

product was established. Costs incurred in 20XX were €20,000 personnel costs and €15,000 legal fees to register the patent. In 20XX, the entity incurred €30,000 to successfully defend a legal suit to protect the patent. The entity would account for these costs as follows:

- Research and development costs incurred in 20XX-1, amounting to €200,000, should be expensed, as they do not meet the recognition criteria for intangible assets. The costs do not result in an identifiable asset capable of generating future economic benefits.
- Personnel and legal costs incurred in 20XX, amounting to €35,000, would be capitalized as patents. The company has established technical and commercial feasibility of the product, as well as obtained control over the use of the asset. The standard specifically prohibits the reinstatement of costs previously recognized as an expense. Thus €200,000, recognized as an expense in the previous financial statements, cannot be reinstated and capitalized.
- Legal costs of €30,000 incurred in 20XX to defend the entity in a patent lawsuit should be expensed. These could be considered as expenses incurred to maintain the asset at its originally assessed standard of performance, would not meet the recognition criteria under IAS 38.
- Alternatively, if the entity were to lose the patent lawsuit, then the useful life and the recoverable amount of the intangible asset would be in question. The entity would be required to provide for any impairment loss, and in all probability, even to fully write off the intangible asset. What is required must be determined by the facts of the specific situation.

### **Measurement Subsequent to Initial Recognition**

IAS 38 acknowledges the validity of two alternative measurement bases: the cost model and the revaluation model. This is entirely comparable to what is prescribed under IAS 16 relative to property, plant and equipment.

#### ***Cost model***

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortization and any accumulated impairment losses.

#### ***Revaluation model***

As with tangible assets, the standard for intangibles permits revaluation subsequent to original acquisition, with the asset being written up to fair value. Inasmuch as most of the particulars of IAS 38 follow IAS 16 to the letter, and were described in detail in Chapter 9, these will not be repeated here. The unique features of IAS 38 are as follows:

1. If the intangibles were not initially recognized (i.e., they were expensed rather than capitalized) it would not be possible to later recognize them at fair value.
2. Deriving fair value by applying a present value concept to projected cash flows (a technique that can be used in the case of tangible assets under IAS 16) is deemed to be too unreliable in the realm of intangibles, primarily because it would tend to commingle the impact of identifiable assets and goodwill. Accordingly, fair value of an intangible asset should *only* be determined by reference to an active market in that type of intangible asset. Active markets providing meaningful data are not expected to exist for such unique assets as patents and trademarks, and thus it is presumed that revaluation will not be applied to these types of assets in the normal course of business. As a consequence, the standard effectively restricts revaluation of intangible assets to freely tradable intangible assets.

As with the rules pertaining to property, plant and equipment under IAS 16, if some intangible assets in a given class are subjected to revaluation, all the assets in that class should be consistently accounted for unless fair value information is not or ceases to be available. Also in common with the requirements for tangible fixed assets, IAS 38 requires that revaluations be recognized in other comprehensive income and accumulated in equity in the revaluation surplus account for that asset, except to the extent that previous impairments had been recognized by a charge against profit or loss, in which case the recovery would also be recognized in profit or loss. If recovery is recognized in profit or loss, any revaluation above what the carrying amount would have been in the absence of the impairment is to be recognized in other comprehensive income.

A recent amendment to IAS 38 has clarified that the gross value is restated (either by reference to market data or proportionally to the change in carrying amount) and that accumulated depreciation is the difference between the new gross amount and the new carrying amount.

#### Example of revaluation of intangible assets

A patent right is acquired July 1, 20XX-1, for €250,000; while it has a legal life of 15 years, due to rapidly changing technology, management estimates a useful life of only five years. Straight-line amortization will be used. At January 1, 20XX, management is uncertain that the process can actually be made economically feasible, and decides to write down the patent to an estimated market value of €75,000. Amortization will be taken over three years from that point. On January 1, 20XX+2, having perfected the related production process, the asset is now appraised at a depreciated replacement cost of €300,000. Furthermore, the estimated useful life is now believed to be six more years. The entries to reflect these events are as follows:

7/1/20XX-1	Patent	250,000	
	Cash, etc.		250,000
12/31/20XX-1	Amortization expense	25,000	
	Patent		25,000
1/1/20XX	Loss from asset impairment	150,000	
	Patent		150,000
12/31/20XX	Amortization expense	25,000	
	Patent		25,000
12/31/20XX+1	Amortization expense	25,000	
	Patent		25,000
1/1/20XX+2	Patent	275,000	
	Gain on asset value recovery		100,000
	Other comprehensive income		175,000

Certain of the entries in the foregoing example will be explained further. The entry at year-end 20XX-1 is to record amortization based on original cost, since there had been no revaluations through that time; only a half-year amortization is provided  $[(€250,000/5) \times 1/2]$ . On January 1, 20XX, the impairment is recorded by writing down the asset to the estimated value of €75,000, which necessitates a €150,000 charge against profit (carrying amount, €225,000, less fair value, €75,000).

In 20XX and 20XX+1, amortization must be provided on the new lower value recorded at the beginning of 20XX; furthermore, since the new estimated life was three years from January 20XX, annual amortization will be €25,000.

As of January 1, 20XX+2, the carrying amount of the patent is €25,000; had the January 20XX revaluation not been made, the carrying amount would have been €125,000 (€250,000 original cost, less two-and-one-half years' amortization versus an original estimated life of five years). The new appraised value is €300,000, which will fully recover the earlier write-down and add even more asset value than the originally recognized cost. Under the guidance of IAS 38, the recovery of €100,000 that had been charged to expense should be recognized as profit; the excess will be recognized in other comprehensive income and increases the revaluation surplus for the asset in equity.

### *Development costs as a special case*

Development costs pose a special problem in terms of the application of the revaluation method under IAS 38. In general, it will not be possible to obtain fair value data from active markets, as is required by IAS 38. Accordingly, the expectation is that the cost method will be almost universally applied for development costs.

If, however, it is determined that fair value information derived from active markets is indeed available, and the entity desires to apply the revaluation method of accounting to development costs, then it will be necessary to perform revaluations on a regular basis, such that at any reporting date the carrying amounts are not materially different from the current fair values. From a mechanical perspective, the adjustment to fair value can be accomplished either by “grossing up” the cost and the accumulated amortization accounts proportionally, or by netting the accumulated amortization, prior to revaluation, against the asset account and then restating the asset to the net fair value as of the revaluation date. In either case, the net effect of the upward revaluation will be recognized in other comprehensive income and accumulated in equity; the only exception would be when an upward revaluation is in effect a reversal of a previously recognized impairment which was reported as a charge against profit or a revaluation decrease (reversal or a yet earlier upward adjustment) which was reflected in profit or loss.

The accounting for revaluations is illustrated below.

#### **Example of accounting for revaluation of development cost**

Assume Breakthrough, Inc. has accumulated development costs that meet the criteria for capitalization at December 31, 20XX, amounting to €39,000. It is estimated that the useful life of this intangible asset will be six years; accordingly, amortization of €6,500 per year is anticipated. Breakthrough uses the allowed alternative method of accounting for its long-lived tangible and intangible assets. At December 31, 20XX+2, it obtains market information regarding the then-current fair value of this intangible asset, which suggests a current fair value of these development costs is €40,000; the estimated useful life, however, has not changed. There are two ways to apply IAS 38: the asset and accumulated amortization can be “grossed up” to reflect the new fair value information, or the asset can be restated on a “net” basis. These are both illustrated below. For both illustrations, the carrying amount (amortized cost) immediately prior to the revaluation is  $€39,000 - (2 \times €6,500) = €26,000$ . The net upward revaluation is given by the difference between fair value and carrying amount, or  $€40,000 - €26,000 = €14,000$ .

**If the “gross up” method is used:** Since the fair value after two years of the six-year useful life have already elapsed is found to be €40,000, the gross fair value must be  $6/4 \times €40,000 = €60,000$ . The entries to record this would be as follows:

Development cost (asset)	21,000	
Accumulated amortization—development cost		7,000
Other comprehensive income		14,000

**If the “netting” method is used:** Under this variant, the accumulated amortization as of the date of the revaluation is eliminated against the asset account, which is then adjusted to reflect the net fair value.

Accumulated amortization—development cost	13,000	
Development cost (asset)		13,000
Development cost (asset)	14,000	
Other comprehensive income—revaluation surplus		14,000

The existing balance in other comprehensive income is closed at the end of the year and its balance accumulated in equity in the revaluation surplus account.

### Amortization Period

IAS 38 requires the entity to determine whether an intangible has a finite or indefinite useful life. An indefinite future life means that there is no foreseeable limit on the period during which the asset is expected to generate net cash inflows. For the entity the standard lists a number of factors to be taken into account:

1. The expected usage by the entity;
2. Typical product life cycles for the asset;
3. Technical, technological, commercial or other types of obsolescence;
4. The stability of the industry in which the asset operates;
5. Expected actions by competitors, or potential competitors;
6. The level of maintenance expenditures required to generate the future economic benefits, and the company’s ability and intention to reach such a level;
7. The period of control over the asset and legal or similar limits on the use of the asset, (such as lease expiry dates);
8. Whether the useful life of the asset is dependent on the useful life of other assets of the company.

Assets having a finite useful life must be amortized over that useful life, and this may be done in any of the usual ways (pro rata over time, over units of production, etc.). If control over the future economic benefits from an intangible asset is achieved through legal rights for a finite period, then the useful life of the intangible asset should not exceed the period of legal rights, unless the legal rights are renewable and the renewal is a virtual certainty. Thus, as a practical matter, the shorter legal life will set the upper limit for an amortization period in most cases.

The amortization method used should reflect the pattern in which the economic benefits of the asset are consumed by the entity. Amortization should commence when the asset is available for use and the amortization charge for each period should be recognized as an expense unless it is included in the carrying amount of another asset (e.g., inventory). Intangible assets may be amortized by the same systematic methods that are used to depreciate property, plant and equipment. Thus, IAS 38 permits straight-line, diminishing balance, and units of production methods. The method used should reflect the expected pattern of the consumption of expected future economic benefits.

IAS 38 was amended effective January 1, 2016 to confirm that depreciation methods based on revenues that are generated by activities including the use of an asset are not appropriate, as revenue generally reflects factors other than the consumption of the economic

benefits inherent within an asset. Basing amortization on revenues is only allowed in two very limited circumstances:

- (i) In the situation that intangible fixed assets are a measure of revenue, i.e., when a limit is made in a contract referring to time or units.  
Example: Company ABC is allowed for six months to extract rubies from a certain designated area due to specific environmental legislation. In this situation it is determined in a contract that there is a limited period in which the company may extract the rubies and as a result intangible fixed assets may be amortized with revenues as a basis.
- (ii) Or the revenue and the realization of economic benefits resulting from the intangible fixed asset are highly correlated.

IAS 38 offers several examples of how useful life of intangibles is to be assessed. These include the following types of assets:

#### ***Customer lists***

Care is urged to ensure that amortization is only over the expected useful life of the acquired list, ignoring the extended life that may be created as the acquirer adds to the list by virtue of its own efforts and costs, after acquisition. In many instances the initial, purchased list will erode in value rather quickly, since contacts become obsolete as customers migrate to other vendors, leave business and so forth. These assets must be constantly refreshed, and that will involve expenditures by the acquirer of the original list (and whether those costs justify capitalization and amortization is a separate issue).

For example, the acquired list might have a useful economic life of only two years (i.e., without additional expenditures, the value will be fully consumed over that time horizon). Two years would be the amortization period, therefore.

#### ***Patents***

While a patent has a legal economic life (depending on jurisdiction of issuance) of as long as several decades, realistically, due to evolving technology and end-product obsolescence or changing customer tastes and preferences, the useful life may be much less. IAS 38 offers an example of a patent having a 15-year remaining life and a firm offer to acquire by a third party in five years, at a fixed fraction of the original acquirer's cost. In such a situation (which is probably unusual, however), amortization of the fraction not to be recovered in the subsequent sale, over a five-year period, would be appropriate.

In other situations, it would be necessary to estimate the economic life of the patent and amortize the entire cost, in the absence of any firmly established residual value, over that period. It should be noted that there is increasing activity involving the monetizing of intellectual property values, including via the packaging of groups of patents and transferring them to special-purpose entities which then license them to third-party licensees. This shows promise of becoming an important way for patent holders to reap greater benefits from existing pools of patents held by them, but is in its infancy at this time and future success cannot be reliably predicted. Amortization of existing acquired patents or other intellectual property (intangible assets) should not be based on highly speculative values that might be obtained from such arrangements.

Additionally, whatever lives are assigned to patents for amortization purposes, these should regularly be reconsidered. As necessary, changes in useful lives should be implemented, which would be changes in estimate affecting current and future periods' amortization only, unless an accounting error had previously been made.



### **Copyrights**

In many jurisdictions copyrights now have very lengthy terms, but for most materials so protected the actual useful lives will be very much shorter, sometimes only a year or two.

### **Renewable license rights**

In many situations the entity may acquire license rights, such as broadcasting of radio or television signals, which technically expire after a fixed term but which are essentially renewable with little or no cost incurred as long as minimum performance criteria are met. If there is adequate evidence to demonstrate that this description is accurate and that the reporting entity has indeed been able, previously, to successfully accomplish this, then the intangible will be deemed to have an indefinite life and not be subjected to periodic amortization. However, this makes it more vital that impairment be regularly reviewed, since even if control of the rights remains with the reporting entity, changes in technology or consumer demand may serve to diminish the value of that asset. If impaired, a charge against earnings must be recognized, with the remaining unimpaired cost (if any) continuing to be recognized as an indefinite life intangible.

Similar actions would be warranted in the case of airline route authority. If readily renewable, without limitation, provided that minimal regulations are complied with (such as maintaining airport terminal space in a prescribed manner), the standard suggests that this be treated as an indefinite-life intangible. Annual impairment testing would be required, as with all indefinite-life intangibles (more often if there is any indication of impairment).

IAS 38 notes that a change in the governmental licensing regime may require a change in how these are accounted for. It cites an example of a change that ends perfunctory renewal and substitutes public auctions for the rights at each former renewal date. In such an instance, the reporting entity can no longer presume to have any right to continue after expiration of the current license, and must amortize its cost over the remaining term.

### **Residual Value**

Tangible assets often have a positive residual value before considering the disposal costs because tangible assets can generally be sold, at least, for scrap, or possibly can be transferred to another user that has less need for or ability to afford new assets of that type. Intangibles, on the other hand, often have little or no residual worth. Accordingly, IAS 38 requires that a zero residual value be presumed unless an accurate measure of residual value is possible. Thus, the residual value is presumed to be zero *unless*:

- There is a commitment by a third party to acquire the asset at the end of its useful life; *or*
- There is an active market for that type of intangible asset, and residual value can be measured reliably by reference to that market and it is probable that such a market will exist at the end of the useful life.

IAS 38 specifies that the residual value of an intangible asset is the estimated net amount that the reporting entity currently expects to obtain from disposal of the asset at the end of its useful life, after deducting the estimated costs of disposal, if the asset were of the age and in the condition expected at the end of its estimated useful life. Changes in estimated selling prices or other variables that occur over the expected period of use of the asset are not to be included in the estimated residual value, since this would result in the recognition of projected future holding gains over the life of the asset (via reduced amortization that would be the consequence of a higher estimated residual value).

Residual value is to be assessed at the end of each reporting period. Any change to the estimated residual, other than that resulting from impairment (accounted for under IAS 36) is to be accounted for prospectively, by varying future periodic amortization. Similarly, any change in amortization method (e.g., from accelerated to straight-line), based on an updated understanding of the pattern of future usage and economic benefits to be reaped therefrom, is dealt with as a change in estimate, again to be reflected only through changes in future periodic charges for amortization.

***Periodic review of useful life assumptions and amortization methods employed***

As for tangible assets accounted for in conformity with IAS 16, the standard on intangibles requires that the amortization period be reconsidered at the end of each reporting period, and that the method of amortization also be reviewed at similar intervals. There is the expectation that due to their nature intangibles are more likely to require revisions to one or both of these judgements. In either case, a change would be accounted for as a change in estimate, affecting current and future periods' reported earnings but not requiring restatement of previously reported periods.

Intangibles being accounted for as having an indefinite life must furthermore be reassessed periodically, as management plans and expectations almost inevitably vary over time. For example, a trademarked product, despite having wide consumer recognition and acceptance, can become irrelevant as tastes and preferences alter, and a limited horizon, perhaps a very short one, may emerge with little warning. Business history is littered with formerly valuable franchises that, for whatever reason—including management missteps—become valueless.

**Impairment Losses**

Where an asset is determined to have an indefinite useful life, the entity must conduct impairment tests annually, as well as whenever there is an indication that the intangible may be impaired. Furthermore, the presumption that the asset has an indefinite life must also be reviewed.

The impairment of intangible assets other than goodwill (such as patents, copyrights, trade names, customer lists and franchise rights) should be considered in precisely the same way that long-lived tangible assets are dealt with. The impairment loss under IAS 36 is the amount by which carrying amount exceeds recoverable amount. Carrying amount must be compared to recoverable amount (the greater of fair value less costs to sell or value in use) when there are indications that an impairment may have been suffered. Net selling price is the price of an asset in an active market less disposal costs, and value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal.

IAS 36 permits reversals of impairment losses on assets other than goodwill under defined conditions. The effects of impairment recognitions and reversals will be reflected in profit or loss, if the intangible assets in question are being accounted for in accordance with the cost method.

On the other hand, if the revaluation method of accounting for intangible assets is followed (use of which is possible only if strict criteria are met), impairments will normally be recognized in other comprehensive income to the extent that revaluation surplus exists, and only to the extent that the loss exceeds previously recognized valuation surplus will the impairment loss be reported as a charge in profit or loss. Recoveries are handled consistent with the method by which impairments were reported, in a manner entirely analogous to the explanation in Chapter 9 dealing with impairments of property, plant and equipment.

Unlike other intangible assets that are individually identifiable, goodwill is amorphous and cannot exist, from a financial reporting perspective, apart from the tangible and identifiable intangible assets with which it was acquired and remains associated. Thus, a direct evaluation of the recoverable amount of goodwill is not actually feasible. Accordingly, IAS 36 requires that goodwill be combined with other assets which together define a cash-generating unit, and that an evaluation of any potential impairment be conducted on an aggregate basis annually. A cash-generating unit (CGU) is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

A more detailed consideration of goodwill is presented in Chapter 15.

Improvements to IFRS issued in 2009 amended the requirements for allocating goodwill to cash-generating units as described in IAS 36, since the definition of operating segments introduced in IFRS 8 affects the determination of the largest unit permitted for goodwill impairment testing in IAS 36. For the purpose of impairment testing, goodwill acquired in a business combination should, from the acquisition date, be allocated to each of the acquirer's cash-generating unit (or groups of cash-generating units) that is expected to benefit from synergies resulting from combination, irrespective of whether other assets or liabilities are allocated to this unit (or units).

Each cash-generating unit should:

1. Represent the lowest level of the entity at which management monitors goodwill (which should be the same as the lowest level of operating segments at which the chief operating decision maker regularly reviews operating results in accordance with IFRS 8); and
2. Not be larger than the operating segment, as defined in IFRS 8, before any permitted aggregation.

### **Derecognition of Intangible Assets**

An intangible asset should be derecognized (1) on disposal, or (2) when no future economic benefits are expected from its use or disposal. With regard to questions of accounting for the disposals of assets, the guidance of IAS 38 is consistent with that of IAS 16. A gain or loss arising from the derecognition of an intangible asset, determined as the difference between its carrying amount and the net disposal proceeds, is recognized in profit or loss (unless IAS 17 requires otherwise on a sale and leaseback) when the asset is derecognized. The 2004 amendment to IAS 38 observes that a disposal of an intangible asset may be effected either by a sale of the asset or by entering into a finance lease. The determination of the date of disposal of the intangible asset is made by applying the criteria in IAS 18 for recognizing revenue from the sale of goods, or IAS 17 in the case of disposal by a sale and leaseback. As for other similar transactions, the consideration receivable on disposal of an intangible asset is to be recognized initially at fair value. If payment for such an intangible asset is deferred, the consideration received is recognized initially at the cash price equivalent, with any difference between the nominal amount of the consideration and the cash price equivalent to be recognized as interest revenue under IAS 18, using the effective yield method.

### **Website Development and Operating Costs**

With the advent of the Internet and of “e-commerce,” most businesses now have their own websites. Websites have become integral to doing business and may be designed either

for external or internal access. Those designed for external access are developed and maintained for the purposes of promotion and advertising of an entity's products and services to their potential consumers. On the other hand, those developed for internal access may be used for displaying company policies and storing customer details.

With substantial costs being incurred by many entities for website development and maintenance, the need for accounting guidance became evident. SIC 32, issued in 2002, concluded that such costs represent an internally generated intangible asset that is subject to the requirements of IAS 38, and that such costs should be recognized if, and only if, an entity can satisfy the requirements set forth in IAS 38. Therefore, website costs have been likened to "development phase" (as opposed to "research phase") costs.

Thus the stringent qualifying conditions applicable to the development phase, such as "ability to generate future economic benefits," have to be met if such costs are to be recognized as an intangible asset. If an entity is not able to demonstrate how a website developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, all expenditure on developing such a website should be recognized as an expense when incurred.

Any internal expenditure on development and operation of the website should be accounted for in accordance with IAS 38. Comprehensive additional guidance is provided in the Appendix to SIC 32 and is summarized below:

1. Planning stage expenditures, such as undertaking feasibility studies, defining hardware and software specifications, evaluating alternative products and suppliers, and selecting preferences, should be expensed;
2. Application and infrastructure development costs pertaining to acquisition of tangible assets, such as purchasing and developing hardware, should be dealt with in accordance with IAS 16;
3. Other application and infrastructure development costs, such as obtaining a domain name, developing operating software, developing code for the application, installing developed applications on the Web server and stress testing, should be expensed when incurred unless the conditions prescribed by IAS 38 are met;
4. Graphical design development costs, such as designing the appearance of Web pages, should be expensed when incurred unless recognition criteria prescribed by IAS 38 are met;
5. Content development costs, such as expenses incurred for creating, purchasing, preparing and uploading information onto the website, to the extent that these costs are incurred to advertize and promote an entity's own products or services, should be expensed immediately, consistent with how other advertising and related costs are to be accounted for under IFRS. Thus, these costs are not deferred, even until first displayed on the website, but are expensed when incurred;
6. Operating costs, such as updating graphics and revising content, adding new functions, registering website with search engines, backing up data, reviewing security access and analysing usage of the website should be expensed when incurred, unless in rare circumstances these costs meet the criteria prescribed in IAS 38, in which case such expenditure is capitalized as a cost of the website; and
7. Other costs, such as selling and administrative overhead (excluding expenditure which can be directly attributed to preparation of website for use), initial operating losses and inefficiencies incurred before the website achieves its planned operating

status, and training costs of employees to operate the website, should all be expensed as incurred as required under IFRS.

## DISCLOSURES

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The disclosure requirements set out in IAS 38 for intangible assets and those imposed by IAS 16 for property, plant and equipment are very similar, and both demand extensive details to be disclosed in the financial statement footnotes. Another marked similarity is the exemption from disclosing “comparative information” with respect to the reconciliation of carrying amounts at the beginning and end of the period. While this may be misconstrued as a departure from the well-known principle of presenting all numerical information in comparative form, it is worth noting that it is in line with the provisions of IAS 1. IAS 1 categorically states that “unless a Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information in the financial statements . . .”. (Another standard that contains a similar exemption from disclosure of comparative reconciliation information is IAS 37—which is dealt with in Chapter 18.)

For each class of intangible assets (distinguishing between internally generated and other intangible assets), disclosure is required of:

1. Whether the useful lives are indefinite or finite and if finite, the useful lives or amortization rates used;
2. The amortization method(s) used;
3. The gross carrying amount and accumulated amortization (including accumulated impairment losses) at both the beginning and end of the period;
4. A reconciliation of the carrying amount at the beginning and end of the period showing additions (analysed between those acquired separately and those acquired in a business combination), assets classified as held-for-sale, retirements, disposals, acquisitions by means of business combinations, increases or decreases resulting from revaluations, reductions to recognize impairments, amounts written back to recognize recoveries of prior impairments, amortization during the period, the net effect of translation of foreign entities’ financial statements, and any other material items; and
5. The line item in the statement of comprehensive income (or statement of profit or loss, if presented separately) in which the amortization charge of intangible assets is included.

The standard explains the concept of “class of intangible assets” as a “grouping of assets of similar nature and use in an entity’s operations.” Examples of intangible assets that could be reported as separate classes are:

1. Brand names;
2. Licenses and franchises;
3. Mastheads and publishing titles;
4. Computer software;
5. Copyrights, patents and other industrial property rights, service and operating right;
6. Recipes, formulae, models, designs and prototypes; and
7. Intangible assets under development.

The above list is only illustrative in nature. Intangible assets may be combined (or disaggregated) to report larger classes (or smaller classes) of intangible assets if this results in more relevant information for financial statement users.

In addition, the financial statements should disclose the following:

1. For any asset assessed as having an indefinite useful life, the carrying amount of the asset and the reasons for considering that it has an indefinite life and the significant factors used to determine this;
2. The nature, carrying amount, and remaining amortization period of any individual intangible asset that is material to the financial statements of the entity as a whole;
3. For intangible assets acquired by way of a government grant and initially recognized at fair value, the fair value initially recognized, their carrying amount, and whether they are carried under the cost or revaluation method for subsequent measurement;
4. The existence and carrying amounts of intangibles with any restrictions on title and the carrying amounts pledged as security for debt; and
5. The amount of outstanding commitments for the acquisition of intangible assets.

Where intangibles are carried using the revaluation model, the entity must disclose the effective date of the revaluation, the carrying amount of the assets, and what their carrying amount would have been under the cost model, the amount of revaluation surplus applicable to the assets and the significant assumptions used in measuring fair value.

The financial statements should also disclose the aggregate amount of research and development expenditure recognized as an expense during the period. The entity is encouraged but not required to disclose any fully amortized assets still in use and any significant assets in use but not recognized because they did not meet the IAS 38 recognition criteria.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURE

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

### 17 Goodwill

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**Cost**

Opening cost at 1 January 20XX-1	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of subsidiary	X
	X

Opening balance at 1 January 20XX	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of a subsidiary	X
	X

**Closing balance at 31 December 20XX** X

**Accumulated impairment**

Opening balance at 1 January 20XX-1	X
Impairment loss	X
	X

Opening balance at 1 January 20XX	X
Impairment loss	X
	X

**Closing balance at 31 December 20XX** X

Opening carrying value at 1 January 20XX-1	X
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Opening carrying value at 1 January 20XX	X
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<b>Closing carrying value at 31 December 20XX</b>	<b>X</b>
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The events and circumstances that led to the recognition of the impairment loss was the disposal of a chain of retail stores in the United Kingdom. No other class of assets was impaired other than goodwill.

[Describe the cash generating units/individual intangible assets of the group and which operating segment they belong to (if any), and whether any impairment losses were recognized or reversed during the period.]

The aggregation of assets for identifying the cash-generating unit has not changed since the prior year.

The recoverable amount of a cash-generating unit is its value in use. In calculating the value in use of the impaired reportable segment the group used a discount rate of X% (20XX-1: X%).

The carrying amount of goodwill allocated to each reportable segment is as follows:

	<b>20XX</b>			
	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>	<b>Total</b>
Home country	X	X	X	X
Other Countries	X	X	X	X

	<b>20XX-1</b>			
	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>	<b>Total</b>
Home country	X	X	X	X
Other Countries	X	X	X	X

Management has based its cash flow projections on cash flow forecasts covering a 5 year period. Cash flows after the 5 year period have been extrapolated based on the estimated growth rates disclosed below. These growth rates do not exceed the long-term average growth rate for the industry or market in which the group operates. Other key assumptions used in the cash flow projections are as follows:

	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>
Growth rates	X	X	X
Discount rates	X	X	X
Gross profit margins	X	X	X

Management has based their assumptions on past experience and external sources of information, such as industry sector reports and market expectations.

#### 18. Other intangible assets

	<b>Development Costs</b>	<b>Patents and Trademarks</b>	<b>Total</b>
<b>Group Cost</b>			
Opening cost at 1 January 20XX-1	X	X	X
Additions	X	X	X
Exchange differences	X	X	X
Disposals	X	X	X
Acquired through business combination	X	X	X

Opening cost at 1 January 20XX	X	X	X
Additions	X	X	X
Exchange differences	X	X	X
Disposals	X	X	X
Acquired through business combination	X	X	X
<b>Closing cost at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>
<b>Accumulated depreciation/impairment</b>			
Opening balance at 1 January 20XX-1			
Amortization	X	X	X
Disposals	X	X	X
Exchange differences	X	X	X
Impairment loss	X	X	X
Opening balance at 1 January 20XX	X	X	X
Amortization	X	X	X
Disposals	X	X	X
Exchange differences	X	X	X
Impairment loss	X	X	X
Impairment reversal	X	X	X
<b>Closing balance at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>
Opening carrying value at 1 January 20XX-1	X	X	X
Opening carrying value at 1 January 20XX	X	X	X
<b>Closing carrying value at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>

The group has a material patent with a carrying amount of £X and a remaining amortization period of X years.

	<b>20XX</b>	<b>20XX-1</b>
Intangible assets pledged as security for liabilities (as disclosed in note X)	<b>X</b>	<b>X</b>

## US GAAP COMPARISON

Internally generated intangible assets are not recognized under US GAAP with the exception of some website developments costs. The underlying reason is that these assets do not have objectively measurable values.

Development costs for software developed for external use are capitalized once the entity establishes technological feasibility.

The entity can make a policy choice to expense advertising as incurred or when the advertising takes place for the first time. If specific criteria are met, direct response advertising may be capitalized.

US GAAP requires impairment loss to be measured as the excess of the carrying amount over the asset's fair value. Impairment loss results in a new cost basis, and impairment loss cannot be reversed for assets to be held and used. Revaluation is not permitted for goodwill and other indefinite-life intangible assets.



On the other hand, IAS 40 requires that all investment property should be consistently accounted for using either the fair value or cost model. Given these requirements, it is held that once the investment alternative is selected for one leased property, all property classified as investment property must be accounted for consistently on a fair value basis.

## DEFINITIONS OF TERMS

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The following terms are used in IAS 40 with the meaning specified:

**Carrying amount.** The amount at which an asset is recognized in the statement of financial position.

**Cost.** The amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRS.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IFRS 13.9).

**Investment property.** Property (land or a building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rental income or for capital appreciation purposes or both, rather than for:

- Use in the production or supply of goods or services or for administrative purposes;
- Sale in the ordinary course of business.

**Owner-occupied property.** Property held (by the owner, i.e. the entity itself or by a lessee under a finance lease), for use in the production or supply of goods or services or for administrative purposes.

## IDENTIFICATION

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The best way to understand what investment property constitutes is to look at examples of investments that are considered by the standard as investment properties, and contrast these with those investments that do not qualify for this categorization.

According to the standard, examples of investment property are:

- Land held for long-term capital appreciation as opposed to short-term purposes like land held for sale in the ordinary course of business;
- Land held for a currently undetermined future use;
- A building owned by the reporting entity (or held by the reporting entity under a finance lease) and leased out under one or more operating leases;
- A vacant building held by an entity to be leased out under one or more operating leases;
- Property under construction or being developed for future use as investment property.

The following are examples of items that are not investment property and are therefore outside the scope of the standard:

- Property employed in the business (i.e., held for use in production or supply of goods or services or for administrative purposes, the accounting for which is governed by IAS 16);

- Owner-occupied property (IAS 16, *Property, Plant and Equipment*), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal;
- Property being constructed or developed on behalf of third parties, the accounting of which is outlined in IAS 11;
- Property held for sale in the ordinary course of business or in the process of construction or development for such sale, the accounting for which is specified by IAS 2;
- Property that is leased to another entity under a finance lease.

Example: Entity X built a residential property with the intention of selling it. In the past, X has regularly developed property and then sold it immediately after completion. To increase the chances of a sale, X chooses to let some of the flats as soon as they are ready for occupation. The tenants move into the property before completion. How has X mapped the property on the balance sheet?

Henceforth, X classifies the property as inventory. This corresponds to X's core business and its strategy regarding property. These undertakings are carried out with the intention of increasing the chances of selling the property and not for the long-term generation of rental income. The property is also not held for the purpose of capital appreciation.

X's intention to sell the property under construction immediately after completion in the ordinary course of business has not changed. Consequently, the property under construction does not fulfill the definition of an investment property (IAS 40.9(a)).

### ***Apportioning property between investment property and owner-occupied property***

In many cases it will be clear what constitutes investment property as opposed to owner-occupied property, but in other instances making this distinction might be less obvious. Certain properties are not held entirely for rental purposes or for capital appreciation purposes. For example, portions of these properties might be used by the entity for manufacturing or for administrative purposes. If these portions, earmarked for different purposes, could be sold, or leased under a finance lease, separately, then the entity is required to account for them separately (dual-use property). However, if the portions cannot be sold, or leased under a finance lease, separately, the property would be deemed as investment property only if an insignificant portion is held by the entity for business use. An example would include that of a shopping mall, in which the landlord maintains an office for the purposes of managing and administering the commercial building, which is rented to tenants.

When ancillary services are provided by the entity and these ancillary services are a relatively insignificant component of the arrangement, as when the owner of a residential building provides maintenance and security services to the tenants, the entity treats such an investment as investment property. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

On the other hand, if the service provided is a comparatively significant component of the arrangement, then the investment would be considered as an owner-occupied property. For instance, an entity that owns and operates a hotel and also provides services to the guests of the hotel would be unable to argue that it is an investment property in the context of IAS 40. Rather, such an investment would be classified as an owner-occupied property.

Judgement is therefore required in determining whether a property qualifies as investment property. It is so important a factor that if an entity develops criteria for determining when to classify a property as an investment property, it is required by this standard to disclose these criteria in the context of difficult or controversial classifications.

#### ***Property leased to a subsidiary or a parent company***

Property leased to a subsidiary or its parent company is considered an investment property from the perspective of the entity in its separate financial statements. However, for the purposes of consolidated financial statements, from the perspective of the group as a whole, it will not qualify as an investment property, since it is an owner-occupied property when viewed from the group perspective (that includes both the lessor and the lessee). This will necessitate the processing of appropriate adjustments to account for the difference in classification when preparing the consolidated accounts.

#### ***Property interest held under operating lease***

IAS 40.6 permits a property interest held by a lessee under an operating lease to be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee used the fair value model for the asset recognized. This classification alternative is available as an accounting policy choice on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property must be accounted for using the fair value model. This would be the case, for example, where one entity (the lessee) leasing a property interest from another entity (lessor) in turn sublets the property to a third entity (the sublessee).

In applying this option permitted by IAS 40.6, although the application of IAS 17.19 may indicate that the lease is in fact an operating lease (see Chapter 22), the lessee would be entitled to account for the lease as a finance lease and capitalize the property interest as investment property, which it in turn sublets under operating lease to the sublessee. This investment property, as well as any other investment properties the lessee might have, would have to be accounted for using the fair value model.

#### ***Interrelationship between IFRS 3 and IAS 40***

The standard is amended through annual improvements to the IFRS 2011–2013 cycle to clarify that IAS 40 and IFRS 3 are not mutually exclusive. The guidance in IAS 40 assists preparers to distinguish between investment property and owner-occupied property. Preparers also need to refer to the guidance in IFRS 3 to determine whether the acquisition of an investment property is a business combination (see Chapter 15). The amendment is effective for annual periods beginning on or after July 1, 2014, but can be applied to individual acquisitions of investment property before that date if, and only if, the information necessary to apply the amendment is available.

## **RECOGNITION AND MEASUREMENT**

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### ***Recognition***

Investment property is recognized as an asset when, and only when, it becomes probable that the entity will enjoy the future economic benefits which are attributable to it, and when the costs of the investment property can be reliably measured.

These recognition criteria are applied to all investment property costs (costs incurred initially to acquire an investment property and subsequent costs to add or to replace a part of an investment property) when the costs are incurred.

In general, this will occur when the property is first acquired or constructed by the reporting entity. In unusual circumstances where it would be concluded that the owner's likelihood of receipt of the economic benefits would be less than probable, the costs incurred would not qualify for capitalization and would consequently have to be expensed.

**Initial measurement** will be at cost, which is usually equivalent to fair value, assuming that the acquisition was the result of an arm's-length exchange transaction. Included in the purchase cost will be such directly attributable expenditure as legal fees and property transfer taxes, if incurred in the transaction.

IAS 40 does not provide explicit guidance on measuring cost for a self-constructed investment property. However, IAS 16 provides that the cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (inventory), which would therefore include overhead charges which can be allocated on a reasonable and consistent basis to the construction activities. To the extent that the acquisition cost includes an interest charge, if the payment is deferred, the amount to be recognized as an investment asset should not include the interest charges, unless the asset meets the definition of a qualifying asset under IAS 23, which requires borrowing costs to be capitalized.

Furthermore, start-up costs (unless they are essential in bringing the property to its working condition), initial operating losses (incurred prior to the investment property achieving planned level of occupancy) or abnormal amounts of wasted material, labour or other resources (in construction or development) do not constitute part of the capitalized cost of an investment property.

If an investment property is acquired in exchange for equity instruments of the reporting entity, the cost of the investment property is the fair value of the equity instruments issued, although the fair value of the investment property received is used to measure its cost if it is more clearly evident than the fair value of the equity instruments issued.

The initial cost of a property interest held under a lease and classified as an investment property must be accounted for by applying IAS 17, *Finance Lease* (IAS 17.19). The asset is recognized at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount is recognized as a liability.

### ***Subsequent expenditures***

In some instances there may be further expenditure incurred on the investment property after the date of initial recognition. Consistent with similar situations arising in connection with property, plant and equipment (dealt with under IAS 16), if the costs meet the recognition criteria discussed above, then those costs may be added to the carrying amount of the investment property. Costs of the day-to-day servicing of an investment property (essentially repairs and maintenance) would not ordinarily meet the recognition criteria, and would therefore be recognized in profit or loss as period costs when incurred. Costs of day-to-day servicing would include the cost of labour and consumables, and may include the cost of minor parts.

Sometimes, the appropriate accounting treatment for subsequent expenditure would depend upon the circumstances that were considered in the initial measurement and

recognition of the investment property. For example, if a property (e.g., an office building) is acquired for investment purposes in a condition that makes it incumbent upon the entity to perform significant renovations thereafter, then such renovation costs (which would constitute subsequent expenditures) will be added to the carrying amount of the investment property when incurred later.

### ***Fair value vs. cost model***

Analogous to the financial reporting of property, plant and equipment under IAS 16, IAS 40 provides that investment property may be reported at either fair value (fair value model) or at depreciated cost less accumulated impairment (cost model). The cost model is the benchmark treatment prescribed by IAS 16 for owner-occupied assets. However, the fair value approach under IAS 40 more closely resembles that used for financial instruments than it does the allowed alternative (revaluation) method for owner-occupied assets. Also, under IAS 40 if the cost method is used, fair value information must nonetheless be determined and disclosed. IAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

### ***Fair value model***

When investment property is carried at fair value, at each subsequent financial reporting date the carrying amount must be adjusted to the then-current fair value, with the adjustment being reported in the profit or loss for the period in which it arises. When choosing the fair value model all of the investment property must be measured at fair value, except when there is an inability to measure fair value reliably (see below). The inclusion of the value adjustments in earnings—in contrast to the revaluation approach under IAS 16, whereby adjustments are generally reported in other comprehensive income—is a reflection of the different roles played by plant or owner-occupied assets and by other investment property. The former are used, or consumed, in the operation of the business, which is often centred upon the production of goods and services for sale to customers. The latter are held for possible appreciation in value, and hence those value changes are highly germane to the assessment of periodic operating performance. With this distinction in mind, the decision was made to not only permit fair value reporting, but to require value changes to be included in profit or loss.

IAS 40 represents the first time that fair value accounting was embraced as an accounting model for non-financial assets. This has been a matter of great controversy, and to address the many concerns voiced during the exposure draft stage, the IASC added more guidance on the subject to the final standard. However, with the issue of IFRS 13, *Fair Value Measurements*, in 2011, much of the fair value guidance in IAS 40 has been superseded with that of IFRS 13 (See Chapter 25).

Entities are alerted to the possibility of double counting in determining the fair value of certain types of investment property. For instance, when an office building is leased on a furnished basis, the fair value of office furniture and fixtures is generally included in the fair value of the investment property (in this case the office building). The apparent rationale is that the rental income relates to the furnished office building; when fair values of furniture and fixtures are included along with the fair value of the investment property, the entity does not recognize them as separate assets.

### ***Inability to measure fair value reliably***

There is a rebuttable presumption that, if an entity acquires or constructs property that will qualify as investment property under this standard, it will be able to assess fair value

reliably on an ongoing basis. In rare circumstances, however, when an entity acquires for the first time an investment property (or when an existing property first qualifies to be classified as investment property when there has been change of use), there may be clear evidence that the fair value of the investment property cannot reliably be determined, on a continuous basis. This arises when, and only when, the market for comparable properties is inactive and alternative reliable measurement of fair value is not available.

Under such exceptional circumstances, the standard stipulates that the entity should measure that investment property using the cost model in IAS 16 until the disposal of the investment property, even if comparable market transactions become less frequent or market prices become less readily available. According to IAS 40, the residual value of such investment property measured under the cost model in IAS 16 should be presumed to be zero. The standard further states that, under the exceptional circumstances explained above, in the case of an entity that uses the fair value model, the entity should measure the other investment properties held by it at fair values. In other words, notwithstanding the fact that one of the investment properties, due to exceptional circumstances, is being carried under the cost model IAS 16, an entity that uses the fair value model should continue carrying the other investment properties at fair values. While this results in a mixed measure of the aggregate investment property, it underlines the perceived importance of the fair value method.

Example: Can a company opt for the fair value model for an investment property under construction, while all other completed investment properties are valued using the acquisition cost model?

No. The company drawing up its balance sheet must choose between using the fair value model (valuation using the fair value) or the acquisition cost model (valuation using the amortized acquisition or construction costs). This decision is only to be made once, and is to be applied equally consistently to all investment properties. This also includes investment properties under construction (IAS 40.33). As such, it is not permitted to value investment properties under construction using the fair value model and all other investment properties under the acquisition cost model. However, in very rare cases, it may be that the company drawing up its balance sheet opts to use the fair value model, however the only investment property in the portfolio to date has been valued using the acquisition cost model in accordance with IAS 16, as the fair value of the property cannot be reliably ascertained (IAS 40.53). In this case, the company drawing up its balance sheet must value the investment property under construction using the acquisition cost model despite using the fair value model for its other investment properties (IAS 40.54).

### ***Cost model***

After initial recognition, investment property is accounted for in accordance with the cost model as set out in IAS 16, *Property, Plant and Equipment*—cost less accumulated depreciation and less accumulated impairment losses—apart from those that meet the criteria to be classified as held-for-sale (or are included in a disposal group held for sale) in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

### ***Transfers to or from investment property***

Transfers to or from investment property should be made only when there is demonstrated “change in use” as contemplated by the standard. A change in use takes place when there is a transfer:



- From investment property to owner-occupied property, when owner-occupation commences;
- From investment property to inventories, on commencement of development with a view to sale;
- From an owner-occupied property to investment property, when owner-occupation ends; or
- From inventories to investment property, when an operating lease to a third party commences.

In the case of an entity that employs the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and thus do not change the cost of that property for measurement or disclosure purposes.

When the investment property is carried under the fair value model, vastly different results follow as far as recognition and measurement is concerned. These are explained below:

**1. Transfers from (or to) investment property to (or from) owner-occupied property (in the case of investment property carried under the fair value model).**

In some instances, property that at first is appropriately classified as investment property under IAS 40 may later become property, plant and equipment as defined under IAS 16. For example, a building is obtained and leased to unrelated parties, but at a later date the entity expands its own operations to the extent that it now chooses to utilize the building formerly held as a passive investment for its own purposes, such as for the corporate executive offices. The amount reflected in the accounting records as the fair value of the property as of the date of change in status would become the cost basis for subsequent accounting purposes. Previously recognized changes in value, if any, would not be reversed.

Similarly, if property first classified as owner-occupied property and treated as property, plant and equipment under the benchmark treatment of IAS 16 is later redeployed as investment property, it is to be measured at fair value at the date of the change in its usage. If the value is lower than the carrying amount (i.e., if there is a previously unrecognized decline in its fair value) then this will be reflected in profit or loss in the period of redeployment as an investment property. On the other hand, if there has been an unrecognized increase in value, the accounting will depend on whether this is a reversal of a previously recognized impairment.

If the increase is a reversal of a decline in value, the increase should be recognized in profit or loss; the amount so reported, however, should not exceed the amount needed to restore the carrying amount to what it would have been, net of depreciation, had the earlier impairment not occurred. If, on the other hand, there was no previously recognized impairment which the current value increase is effectively reversing (or, to the extent that the current increase exceeds the earlier decline), then the increase should be recognized in other comprehensive income. If the investment property is later disposed of, any surplus in equity should be transferred to retained earnings without being recognized through profit or loss.

**2. Transfers from inventories to investment property (in the case of investment property carried under the fair value model).**

It may also happen that property originally classified as inventories, originally held for sale in the normal course of the business, is later redeployed as investment

property. When reclassified, the initial carrying amount should be fair value as of that date. Any difference between the fair value and the carrying amount of the property at the date of transfer would be reported in profit or loss. This is consistent with the treatment of sales of inventories.

Example: Can a property under construction classified as inventory be reclassified as an investment property if the disposal plans no longer exist?

No, a property under construction that has to date been classified as inventory is not to be reclassified solely on the basis of its intended use being changed. This requires for example an operating lease agreement to be commenced [IAS 40.57(d)].

### 3. Transfers from investment property to inventories.

IAS 40 requires an investment property to be transferred to inventories only when there is a change of use evidenced by commencement of development with a view to sale. When an investment property carried at fair value is transferred to inventories, the property's deemed cost for subsequent accounting in accordance with IAS 2 Inventories is its fair value at the date of change in use.

When the entity determines that property held as investment property is to be sold, that property should be classified as a non-current asset held for sale in accordance with IFRS 5. It should not be derecognized (eliminated from the statement of financial position) or transferred to inventories. The treatment of non-current assets held for sale is discussed in further detail in Chapter 9. However, in the case of investment property held for sale, these continue to be measured at fair value in accordance with IAS 40 up to the point of sale, unlike for example, property, plant and equipment which is measured at the lower of carrying amount or fair value less costs to sell while held for sale.

Example: Can a property that has previously been classified as an investment property be reclassified as inventory if it is renovated to create saleability?

Yes, if the renovation is a development that significantly increases the value of the property. This may be the case when a significantly higher rental standard is achieved through renovation or when the lettable area is significantly increased. However, if the renovation only serves to maintain the property at its current level, then in accordance with IAS 40.57(b), there is no development with the aim of sale.

### *Disposal and retirement of investment property*

An investment property should be derecognized (i.e., eliminated from the statement of financial position of the entity) on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal. The word "disposal" has been used in the standard to mean not only a sale but also the entering into of a finance lease by the entity. In determining the date of disposal of an investment property, the criteria in IAS 18, *Revenue* for recognizing revenue from the sale of goods should be applied. IAS 17, *Leases* applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

Any gains or losses on disposal or retirement of an investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognized in profit or loss for the period of the retirement or disposal. This is subject to the requirements of IAS 17 in the case of sale and leaseback transactions.



## Deferred Tax

A December 2010 amendment to IAS 12, *Income Taxes*, was introduced to provide a practical approach for measuring deferred tax liabilities and deferred tax assets when investment property is measured using the fair value model. Under IAS 12, the measurement of deferred tax liabilities and deferred tax assets depends on whether an entity expects to recover an asset by using it or by selling it. However, it is often difficult and subjective to determine the expected manner of recovery when the investment property is measured at fair value.

The amendment introduced a rebuttable presumption that deferred tax on investment property measured using the fair value model should be determined on the basis that its carrying amount will be recovered through sale. To address this issue, IAS 12, as amended, includes a rebuttal that the carrying amount of investment property measured using the fair value model in IAS 40 will be recovered through sale and, accordingly, that any related deferred tax should be measured on a sale basis. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. (See Chapter 26.)

## PRESENTATION AND DISCLOSURE

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### *Presentation*

IAS 1, *Presentation of Financial Statements* requires that, when material, the aggregate carrying amount of the entity's investment property should be presented in the statement of financial position.

### *Disclosure*

It is anticipated that in certain cases investment property will be property that is owned by the reporting entity and leased to others under operating-type lease arrangements. The disclosure requirements set forth in IAS 17 (and discussed in Chapter 22) continue unaltered by IAS 40. In addition, IAS 40 stipulates a number of new disclosure requirements set out below.

#### **1. Disclosures applicable to all investment properties (general disclosures)**

- There is a requirement to disclose whether the entity applies the fair value or the cost model.
- When classification is difficult, an entity that holds an investment property will need to disclose the criteria used to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.
- The methods and any significant assumptions that were used in ascertaining the fair values of the investment properties are to be disclosed as well. Such disclosure also includes a statement about whether the determination of fair value was supported by market evidence or relied heavily on other factors (which the entity needs to disclose as well) due to the nature of the property and the absence of comparable market data.

This disclosure regarding the methods and significant assumptions underlying the determination of fair value is not required for entities that have adopted IFRS 13, *Fair Value Measurement*. Such entities should instead provide the disclosures required under IFRS 13 (see Chapter 25).

- If investment property has been revalued by an independent appraiser, having recognized and relevant qualifications, and who has recent experience with properties having similar characteristics of location and type, the extent to which the fair value of investment property (either used in case the fair value model is used or disclosed in case the cost model is used) is based on valuation by such a qualified independent valuation specialist. If there is no such valuation, that fact should be disclosed as well.
- The following should be disclosed in the statement of comprehensive income:
  - The amount of rental income derived from investment property.
  - Direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period.
  - Direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period.
  - The cumulative change in fair value recognized in profit and loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used.
- The existence and the amount of any restrictions which may potentially affect the realizability of investment property or the remittance of income and proceeds from disposal to be received.
- Material contractual obligations to purchase or build investment property or to make repairs, maintenance or improvements thereto.

## 2. Disclosures applicable to investment property measured using the fair value model

In addition to the disclosures outlined above, the standard requires that an entity that uses the fair value model should present a reconciliation of the carrying amounts of the investment property, from the beginning to the end of the reporting period, showing the following:

- Additions, disclosing separately those additions resulting from acquisitions, those resulting from business combinations, and those deriving from capitalized expenditures subsequent to the property's initial recognition.
- Assets classified as held-for-sale, or included in a disposal group classified as held-for-sale, in accordance with IFRS 5 and other disposals.
- Net gains or losses from fair value adjustments.
- The net exchange differences, if any, arising from the translation of the financial statements of a foreign entity.
- Transfers to and from inventories and owner-occupied property.
- Any other movements.

Comparative reconciliation data for prior periods need not be presented.

Under exceptional circumstances, due to lack of reliable fair value, when an entity measures investment property using the benchmark (cost) treatment under IAS 16, the above reconciliation should disclose amounts separately for that investment property from amounts relating to other investment property. In addition, an entity should disclose:

- A description of such an investment property;
- An explanation of why fair value cannot be reliably measured;
- If possible, the range of estimates within which fair value is highly likely to lie;

- On disposal of such an investment property, the fact that the entity has disposed of investment property not carried at fair value along with its carrying amount at the time of disposal and the amount of gain or loss recognized.

When a valuation obtained for an investment property is adjusted significantly for the purpose of the financial statements (e.g., to avoid double counting of assets or liabilities that are recognized as separate assets and liabilities), the entity is required to present a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognized lease obligation that has been added back and any other significant adjustments.

### 3. Disclosures applicable to investment property measured using the cost model

In addition to the general disclosure requirements outlined in 1. above, the standard requires that an entity that applies the cost model should disclose:

- The depreciation methods used;
- The useful lives or the depreciation rates used;
- The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;
- A reconciliation of the carrying amount of investment property at the beginning and the end of the period showing the following details:
  - Additions resulting from acquisitions, those resulting from business combinations and those deriving from capitalized expenditures subsequent to the property's initial recognition;
  - Disposals, depreciation, impairment losses recognized and reversed, the net exchange differences, if any, arising from the translation of the financial statements of a foreign entity, transfers to and from inventories and owner-occupied properties, and any other movements.

Comparative reconciliation data for prior periods need not be presented.

- The fair value of investment property carried under the cost model. In exceptional cases, when the fair value of the investment property cannot be reliably estimated, the entity should instead disclose:
  - A description of such property;
  - An explanation of why fair value cannot be reliably measured;
  - If possible, the range of estimates within which fair value is highly likely to lie.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

### 2. Significant accounting policies

#### 2.6 Investment properties

Investment property comprises non-owner occupied buildings held to earn rentals and for capital appreciation.

IAS40 p75

Investment properties are initially recognized at cost, inclusive of transaction costs. Subsequently, investment properties are measured at fair value. Gains and losses arising from changes in the fair value of investment properties are recognized in profit or loss in the period in which they arise.

Investment property is derecognized when disposed of, or when no future economic benefits are expected from the disposal. Any gain or loss arising on derecognition of the property is recognized in profit or loss in the period in which the property is derecognized.

## 16. Investment property

### Fair value model

The fair value of the group's investment properties are determined annually at the reporting date by an independent professionally qualified valuer. In determining the valuations the valuator refers to current market conditions and recent sales transactions of similar properties. In estimating the fair value of the properties, the highest and best use of the property is their current use. There has been no change in the valuation technique used during the year.

IAS40 p75  
IFRS13 p91  
p93

Amounts recognized in profit or loss:	20XX	20XX-1	IAS40 p75
Rental income	X	X	
Direct operating expenses			
On property that generated rental income	X	X	
On property that did not generate rental income	X	X	

Investment properties with a carrying amount of £ X (20XX-1: £ X) has been pledged as security for liabilities. The holder of the security does not have the right to sell or re-pledge the investment properties in the absence of default.

IFRS7  
p14

	20XX	20XX-1	IAS40 p76
Carrying value at the beginning of the year	X	X	
Fair value changes	X	X	
Exchange differences	X	X	
Additions	X	X	
Carrying value at the end of the year	<u>X</u>	<u>X</u>	

### Fair value hierarchy

	Level 1	Level 2	Level 3	Fair value	IFRS13 p93
Rental property units located in X area	-	-	X	X	

The fair valuation of investment property is considered to represent a level 3 valuation based on significant non-observable inputs being the location and condition of the property, consistent with prior periods.

IFRS13 p93(c)

Management does not expect there to be a material sensitivity to the fair values arising from the non-observable inputs.

There were no transfers between level 1, 2 or 3 fair values during the year.

The table above presents the changes in the carrying value of the investment property arising from these fair valuation assessments.

**US GAAP COMPARISON**

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US GAAP does not separately define investment properties. Investment property is accounted for as held for use or held for sale.

Revaluation of assets is not permitted.

## DEFINITIONS OF TERMS

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**Asset held for sale.** A non-current asset or a group of assets (disposal group) to be disposed of in a single transaction, together with directly associated liabilities. Assets classified as held-for-sale are not subject to depreciation and are carried at the lower of carrying amount and fair value less costs to sell. Separate classification of “assets and liabilities held for sale” in the statement of financial position is required.

**Carrying amount (book value).** The value reported for an asset or liability in the statement of financial position. For assets, this is either cost, revalued amount, or cost minus offsets such as depreciation or allowance for bad debts. Carrying amount of property, plant, and equipment is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses. Carrying amount is often different from market value because depreciation is a cost allocation rather than a means of valuation. For liabilities, the carrying amount is the amount of the liability minus offsets such as any sums already paid or bond discounts.

**Cash-generating unit.** The smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows associated with other assets or groups of assets; used for impairment testing purposes.

**Commercial substance.** The ability to change an entity’s future cash flows; used in determining the accounting for certain non-monetary exchanges.

**Component of an entity.** Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

**Corporate assets.** Assets, excluding goodwill, that contribute to future cash flows of both the cash-generating unit under review for impairment as well as other cash-generating units of the entity.

**Cost.** Amount of cash or cash equivalent paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRS (e.g., IFRS 2, *Share-Based Payment*).

**Costs of disposal.** The incremental costs directly associated with the disposal of an asset; these do not include financing costs or related income tax effects (IAS 36).

**Costs to sell.** The incremental costs directly attributed to a disposal of an asset (or disposal group), excluding finance costs and income tax expense (IFRS 5).

**Current asset.** An asset should be classified as a current asset when it satisfies any one of the following:

1. It is expected to be realized in, or is held for sale or consumption in, the normal operating course of the entity’s operating cycle;
2. It is held primarily for trading purposes;
3. It is expected to be realized within 12 months after the reporting period; or
4. It is cash or a cash equivalent (as defined in IAS 7) that is not restricted in its use.

**Discontinued operation.** A component of an entity that either has been disposed of or is classified as held-for-sale and satisfies any one of the following:

1. It is a separate major line of business or geographical area of operations;
2. It is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or

3. It is a subsidiary acquired exclusively with a view to resale.

**Disposal group.** A group of assets (and liabilities associated with those assets) to be disposed of, by sale or otherwise, together as a group in a single transaction. Goodwill acquired in a business combination is included in the disposal group if this group is a cash-generating unit to which goodwill has been allocated in accordance with IAS 36 or if it is an operation within such a cash-generating unit.

**Exchange.** Reciprocal transfer between an entity and another entity that results in the acquisition of assets or services, or the satisfaction of liabilities, through a transfer of other assets, services or other obligations.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in orderly transaction between market participants at the measurement date.

**Fair value less costs to sell.** The amount obtainable from the sale of an asset in an arm's-length transaction between knowledgeable, willing parties, less the costs of disposal.

**Firm purchase commitment.** An agreement with an unrelated party, binding on both parties and usually legally enforceable, that (1) specifies all important terms, including the price and timing of the transactions, and (2) includes a disincentive for non-performance (sufficiently large) making performance highly probable.

**Highly probable.** Significantly more likely than probable.

**Impairment loss.** The excess of the carrying amount of an asset or a cash-generating unit over its recoverable amount.

**Impairment test.** Recoverability test, comparing the carrying amount of an asset in the statement of financial position to its recoverable amount ensure that no asset is carried at more than its fair value. In general, impairment occurs when a company can no longer generate sufficient future cash inflows to recover the value of an asset.

**Intangible assets.** Identifiable non-monetary assets, without physical substance.

**Non-current asset.** An asset not meeting the definition of a current asset.

**Probable.** More likely than not.

**Provision.** A liability established to recognize a probable outflow of resources, whose timing or value is uncertain, where the reporting entity has a present obligation arising out of a past event.

**Recoverable amount.** The greater of an asset's fair values less costs to sell or its value in use.

**Value in use.** The present value of estimated future cash flows expected to be realized from the continuing use of an asset and from its disposal at the end of its useful life.

## IMPAIRMENT OF ASSETS (IAS 36)

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### *Scope of IAS 36*

IAS 36 is applicable to all assets except:

- Inventories (IAS 2);
- Assets arising from construction contracts (IAS 11);
- Deferred tax assets (IAS 12);
- Assets arising from employee benefits (IAS 19);
- Financial assets within the scope of IAS 39 or IFRS 9;
- Investment property measured at fair value (IAS 40);
- Biological assets related to agricultural activity measured at fair value less costs to sell (IAS 41);

- Deferred acquisition costs and intangible assets under insurance contracts (IFRS 4); and
- Non-current assets (or disposal groups) classified as held-for-sale (IFRS 5).

This standard applies to financial assets classified as:

- Subsidiaries, as defined in IFRS 10, *Consolidated Financial Statements*;
- Associates, as defined in IAS 28, *Investments in Associates and Joint Ventures*; and
- Joint ventures, as defined in IFRS 11, *Joint Arrangements*.

### ***Principal requirements of IAS 36***

In general, the standard provides the procedures that an entity is required to apply to ensure that its assets are not carried at amounts higher than their recoverable amount. If an asset's carrying amount is more than its recoverable amount (the amount to be recovered through use or sale of the asset), an impairment loss is recognized. IAS 36 requires an entity to assess at the end of each reporting period whether there is any indication that an asset may be impaired. Tests for impairment are only necessary when there is an indication that an asset might be impaired (but annually for intangible assets having an indefinite useful life, intangible assets not yet available for use, and goodwill). When carried out, the test is applied to the smallest group of assets for which the entity has identifiable cash flows, called a "cash-generating unit." The carrying amount of the asset or assets in the cash-generating unit is compared with the recoverable amount, which is the higher of the asset's (or cash-generating units) fair value less costs to sell and the present value of the cash flows expected to be generated by using the asset ("value in use"). If the higher of these future values is lower than the carrying amount, an impairment loss is recognized for the difference.

### ***Identifying impairments***

According to IAS 36, at each financial reporting date the reporting entity should determine whether there are conditions that would indicate that impairments may have occurred. Note that this is *not* a requirement that possible impairments be calculated for all assets at the end of each reporting period, which would be a formidable undertaking for most entities. Rather, it is the existence of conditions that might be suggestive of a heightened risk of impairment that must be evaluated. However, if such indicators are present, then further analysis will be necessary.

The standard provides a set of indicators of potential impairment and suggests that these represent a minimum array of factors to be given consideration. Other more industry- or entity-specific gauges could be devised by the reporting entity.

At a minimum, the following external and internal signs of possible impairment are to be given consideration on an annual basis:

- Market value declines for assets, beyond the declines expected as a function of asset aging and use;
- Significant changes in the technological, market, economic or legal environments in which the entity operates, or the specific market to which the asset is dedicated;
- Increases in the market interest rate or other market-oriented rate of return such that increases in the discount rate to be employed in determining value in use can be anticipated, with a resultant enhanced likelihood that impairments will emerge;



- Declines in the entity's market capitalization suggest that the aggregate carrying amount of assets exceeds the perceived value of the entity taken as a whole;
- There is specific evidence of obsolescence or of physical damage to an asset or group of assets;
- There have been significant internal changes to the organization or its operations, such as product discontinuation decisions or restructurings, so that the expected remaining useful life or utility of the asset has seemingly been reduced; and
- Internal reporting data suggest that the economic performance of the asset or group of assets is, or will become, worse than previously anticipated.

The mere fact that one or more of the foregoing indicators suggests that there might be cause for concern about possible asset impairment does not necessarily mean that formal impairment testing must proceed in every instance, although in the absence of a plausible explanation why the signals of possible impairment should not be further considered, the implication would be that some follow-up investigation is needed.

### *Computing recoverable amounts—general concepts*

IAS 36 defines impairment as the excess of carrying amount over recoverable amount, and defines recoverable amount as the greater of two alternative measures: fair value less costs to sell and value in use. The objective is to recognize impairment when the economic value of an asset (or cash-generating unit comprised of a group of assets) is truly below its book (carrying) value. In theory, and for the most part in practice also, an entity making rational choices would sell an asset if its net selling price (fair value less costs to sell) were greater than the asset's value in use, and would continue to employ the asset if value in use exceeded salvage value. Thus, the economic value of an asset is most meaningfully measured with reference to the greater of these two amounts, since the entity will either retain or dispose of the asset, consistent with what appears to be its highest and best use. Once recoverable amount has been determined, this is to be compared to carrying amount; if recoverable amount is lower, the asset has been impaired, and this impairment must be given accounting recognition. It should be noted that value in use is an entity-specific value, in contrast to fair value, which is based on market price. Value in use is thus a much more subjective measurement than is fair value, since it takes account of factors available only to the individual business, which may be difficult to validate. If either an asset's fair value less costs to sell or its value in use exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

### *Determining fair value less costs to sell*

The determination of the fair value less costs to sell (i.e., net selling price) and the value in use of the asset being evaluated will typically present some difficulties. For actively traded assets, fair value can be ascertained by reference to publicly available information (e.g., from price lists or dealer quotations), and costs of disposal will either be implicitly factored into those amounts (such as when a dealer quote includes pick-up, shipping, etc.) or else can be readily estimated. Most common productive tangible assets, such as machinery and equipment, will not easily be priced, since active markets for used items will either not exist or be relatively illiquid. It will often be necessary to reason by analogy (i.e., to draw inferences from recent transactions in similar assets), making adjustments for age, condition, productive capacity and other variables. For example, a five-year-old machine having an output

rate (for a given component) of 2,000 units per day, and an estimated useful life of eight years, might be valued at 30% ( $=3/8 \times 2,000/2,500$ ) of the cost of a new replacement machine having a capacity of 2,500 units per day. In many industries, trade publications and other data sources can provide a great deal of insight into the market value of key assets. IFRS 13, *Fair Value Measurement* deals specifically with these issues, refer to Chapter 25 for more detail on how IFRS suggests these values are to be determined.

### ***Computing value in use***

The computation of value in use involves a two-step process: first, future cash flows must be estimated; and second, the present value of these cash flows must be calculated by application of an appropriate discount rate. These will be discussed in turn in the following paragraphs.

Projection of future cash flows must be based on reasonable assumptions. Exaggerated revenue growth rates, significant anticipated cost reductions, or unreasonable useful lives for plant assets must be avoided if meaningful results are to be obtained. In general, recent past experience is a fair guide to the near-term future, but a recent sudden growth spurt should not be extrapolated to more than the very near-term future. For example, if growth over the past five years averaged 5%, but in the latest year equaled 15%, unless the recent rate of growth can be identified with factors that demonstrate it as being sustainable, a future growth rate of 5%, or slightly higher, would be more supportable.

Typically, extrapolation cannot be made to a greater number of future periods than the number of “base periods” upon which the projection is built. Thus, a five-year projection, to be sound, should be based on at least five years of actual historical performance data. Also, since no business can grow exponentially forever—even if, for example, a five-year historical analysis suggests a 20% annual (inflation-adjusted) growth rate—beyond a horizon of a few years a moderation of that growth must be hypothesized. (Reversion to the mean growth rate for the industry as a whole, or of some other demographic trend, such as population growth, is usually assumed.) This is even more important for a single asset or small cash-generating unit, since physical constraints and the ironclad law of diminishing marginal returns makes it virtually inevitable that a plateau will be reached, beyond which further growth will be strictly constrained. Basic economic laws suggest that, if exceptional returns are being reaped from the assets used to produce a given product line, competitors will enter the market, driving down prices and limiting future profitability.

IAS 36 stipulates that steady or declining growth rates must be utilized for periods beyond those covered by the most recent budgets and forecasts. It further states that, barring an ability to demonstrate why a higher rate is appropriate, the growth rate should not exceed the long-term growth rate of the industry in which the entity participates.

The guidance offered by IAS 36 suggests that only normal, recurring cash inflows and outflows from the continuing use of the asset being evaluated should be considered, to which would be added any estimated salvage value at the end of the asset’s useful life. In determining the cash flows from operations, the company should take into account the effect of the business developments on working capital requirements. These working capital requirements include both assets and liabilities and can be positive and negative. For example, if a growth of revenues is estimated for the coming five years, it can be expected that under normal business circumstances, the receivables increase in a similar direction. The same would be the case for any prepayment of services, for instance in the publishing industry, where many subscriptions are paid up-front.

Non-cash costs, such as depreciation of the asset, obviously must be excluded from this calculation, since, in the case of depreciation, this would in effect double count the very item being measured. Furthermore, projections should always exclude cash flows related to financing the asset—for example, interest and principal repayments on any debt incurred in acquiring the asset—since operating decisions (e.g., keeping or disposing of an asset) are to be evaluated separately from financing decisions (borrowing, leasing, buying with equity capital funds). Also, cash flow projections must relate to the asset in its existing state and in its current use, without regard to possible future enhancements. Income tax effects are also to be disregarded (i.e., the entire analysis should be on a pre-tax basis). An entity should translate the present value of future cash flows estimated in the foreign currency using the spot exchange rate at the date of the value-in-use calculation.

### ***Cash-generating units***

Under IAS 36, when cash flows cannot be identified with individual assets, (as will frequently be the case), assets must be grouped in order to permit an assessment of future cash flows. The requirement is that this grouping be performed at the lowest level possible, which would be the smallest aggregation of assets for which discrete cash flows can be identified, and which are independent of other groups of assets. In practice, this unit may be a department, a product line, or a factory, for which the output of product and the input of raw materials, labour, and overhead can be identified.

Thus, while the precise contribution to overall cash flow made by, say, a given drill press or lathe, may be impossible to surmise, the cash inflows and outflows of a department which produces and sells a discrete product line to an identified group of customers can be more readily determined. To comply with IFRS, the extent of aggregation must be the minimum necessary to develop cash flow information for impairment assessment, and no greater.

A too-high level of aggregation is prohibited for a very basic reason: doing so could permit some impairments to be concealed, by effectively offsetting impairment losses against productivity or profitability gains derived from the expected future use of other assets. Consider an entity which is, overall, quite profitable and which generates positive cash flow, although certain departments or product lines are significantly unprofitable and cash drains. If aggregation at the entity level were permitted, there would be no impairment to be recognized, which would thwart IAS 36's objectives. If impairment testing were done at the departmental or product line level, on the other hand—consistent with IAS 36 requirements—then some loss-producing assets would be written down for impairment, while the cash-generating assets would continue to be accounted for at depreciated historical cost.

Put another way, excessive aggregation results (when there are both cash-generating and cash-using groups of operating assets, departments or product lines) in the recognition of unrealized gains on some assets that nominally are being accounted for on the historical cost basis, which violates IFRS. These gains, while concealed and not reported as such, offset the impairment losses on assets (or groups of assets) whose values have suffered diminutions in value. IAS 36 does not permit this result to be obtained.

IAS 36 requires that cash-generating units be defined consistently from period to period. In addition to being necessary for consistency in financial reporting from period to period, which is an important objective per se, it is also needed to preclude the opportunistic redefining of cash-generating groups affected in order to minimize or eliminate impairment recognition.

### **Discount rate**

The other measurement issue in computing value in use comes from identifying the appropriate discount rate to apply to projected future cash flows. The discount rate is comprised of subcomponents. The base component of the discount rate is the current market rate, which should be identical for all impairment testing at any given date. This must be adjusted for the risks specific to the asset, which thus adds the second component of discount rate.

In practice, this asset class risk adjustment can be built into the cash flows. Appendix A to the standard discusses what it describes as the *traditional approach* to present value calculation, where forecast cash flows are discounted using a rate that is adjusted for uncertainties. It also describes the *expected cash flow* method, where the forecast cash flows are directly adjusted to reflect uncertainty and then discounted at the market rate. These are alternative approaches and care must be exercised to apply one or the other correctly. Most importantly, risk should not be adjusted for twice in computing the present value of future cash flows.

IAS 36 suggests that identifying the appropriate risk-adjusted cost of capital to employ as a discount rate can be accomplished by reference to the implicit rates in current market transactions (e.g., leasing transactions), or from the weighted-average cost of capital of publicly traded entities operating in the same industry grouping. Such statistics are available for certain industry segments in selected (but not all) markets. The entity's own recent transactions, typically involving leasing or borrowing to buy other long-lived assets, will be highly salient information in estimating the appropriate discount rate to use.

When risk-adjusted rates are not available, however, it will become necessary to develop a discount rate from surrogate data. The two steps to this procedure are:

1. To identify the pure time value of money for the requisite time horizon over which the asset will be utilized; and
2. To add an appropriate risk premium to the pure interest factor, which is related to the variability of future cash flows or other, sometimes unidentifiable, factors that market participants would reflect in the pricing.

Regarding the first component, the life of the asset being tested for impairment will be critical; short-term obligations almost always carry a lower rate than intermediate-or long-term ones, although there have been periods when "yield curve inversions" have been dramatic. As to the second element, projected future cash flows having greater variability (which is the technical definition of risk) will be associated with higher risk premiums.

Of these two discount rate components, the latter is likely to prove the more difficult to determine or estimate, in practice. IAS 36 provides discussion of the methodology to utilize, and this should be carefully considered before embarking on this procedure. It addresses such factors as country risk, currency risk and pricing risk but also the (il) liquidity of the (group of) asset. The latter is also referred to as the small-firm premium.

The interest rate is considered to include an inflation risk component (i.e., to represent nominal rates, rather than real or inflation-adjusted rates), and to calculate present value consistent with this fact, the forecast cash flows should reflect the monetary amounts expected to be received in the future, rather than being adjusted to current price levels.

The interest rate to apply must reflect current market conditions as of the end of the reporting period. This means that during periods when rates are changing rapidly the computed value in use of assets will also change, perhaps markedly, even if projected cash

flows before discounting remain stable. This is not a computational artifact, however, but rather it reflects economic reality: as discount (interest) rates decline, holdings of productive assets become more economically valuable, holding all other considerations constant; and as rates rise, such holdings lose value because of the erosion of the value of their future cash flows. The accounting implication is that long-lived assets that were unimpaired one year earlier may fail an impairment test in the current period if rates have risen during the interim.

### *Corporate assets*

Corporate assets, such as headquarters buildings and shared equipment, which do not themselves generate identifiable cash flows, need to be tested for impairment as with all other long-lived assets. However, these present a particular problem in practice due to the inability to identify cash flows deriving from the future use of these assets. A failure to test corporate assets for impairment would permit such assets to be carried at amounts that could, under some circumstances, be at variance with requirements under IFRS. It would also permit a reporting entity to deliberately evade the impairment testing requirements by opportunistically defining certain otherwise productive assets as being corporate assets.

To avoid such results, IAS 36 requires that corporate assets be allocated among or assigned to the cash-generating unit or units with which they are most closely associated. For a large and diversified entity, this probably implies that corporate assets will be allocated among most or all of its cash-generating units, perhaps in proportion to annual turnover (revenue). Since ultimately an entity must generate sufficient cash flows to recover its investment in all long-lived assets, whether assigned to operating divisions or to administrative groups, there are no circumstances in which corporate assets can be isolated and excluded from impairment testing.

### *Accounting for impairments*

If the recoverable amount of the cash-generating unit is lower than its carrying amount, an impairment must be recognized. The mechanism for recording an impairment loss depends upon whether the entity is accounting for long-lived assets on the historical cost subject to depreciation or revaluation basis. Impairments computed for assets carried at historical cost will be recognized as charges against current period profit or loss, either included with depreciation for financial reporting, or identified separately in the statement of profit or loss, if prepared separately, or in the statement of comprehensive income.

For assets grouped into cash-generating units, it will not be possible to determine which specific assets have suffered impairment losses when the unit as a whole has been found to be impaired, and so IAS 36 prescribes a formulaic approach. If the cash-generating unit in question has been allocated any goodwill, any impairment should be allocated fully to goodwill, until its carrying amount has been reduced to zero. Any further impairment would be allocated proportionately to all the other assets in that cash-generating unit. In practice, the impairment loss is allocated against the non-monetary assets that are carried, as the carrying amount of monetary assets usually approximates actual.

The standard does not specify whether the impairment should be credited to the asset account or to the accumulated depreciation (contra asset) account. Of course, either approach has the same effect: net carrying amount is reduced by the accumulated impairment recognized. European practice has generally been to add impairment provisions to the

accumulated depreciation account. This is consistent with the view that reducing the asset account directly would be a contravention of the general prohibition on offsetting.

If the entity employs the revaluation method of accounting for long-lived assets, the impairment adjustment will be treated as the partial reversal of a previous upward revaluation. However, if the entire revaluation account is eliminated due to the recognition of an impairment, any excess impairment should be charged to expense (and thus be closed out to profit or loss). In other words, the revaluation account cannot contain a net debit balance.

#### Example of accounting for impairment

Xebob Corporation (XC) has one of its (many) departments that performs machining operations on parts that are sold to contractors. A group of machines have an aggregate carrying amount at the end of the latest reporting period (December 31, 20XX) totaling €123,000. It has been determined that this group of machinery constitutes a cash-generating unit for purposes of applying IAS 36.

Upon analysis, the following facts about future expected cash inflows and outflows become apparent, based on the diminishing productivity expected of the machinery as it ages, and the increasing costs that will be incurred to generate output from the machines:

<u>Year</u>	<u>Revenues</u>	<u>Costs, excluding depreciation</u>
20XX+1	€ 75,000	€ 28,000
20XX+2	80,000	42,000
20XX+3	65,000	55,000
20XX+4	20,000	15,000
Totals	<u>€240,000</u>	<u>€140,000</u>

The fair value of the machinery in this cash-generating unit is determined by reference to used machinery quotation sheets obtained from a prominent dealer. After deducting estimated disposal costs, the fair value less costs to sell is calculated as €84,500.

Value in use is determined with reference to the above-noted expected cash inflows and outflows, discounted at a risk rate of 5%. This yields a present value of about €91,981, as shown below.

<u>Year</u>	<u>Cash flows</u>	<u>PV factors</u>	<u>Net PV of cash flows</u>
20XX+1	€47,000	.95238	€44,761.91
20XX+2	38,000	.90703	34,467.12
20XX+3	10,000	.86384	8,638.38
20XX+4	5,000	.82270	4,113.51
Total			<u>€91,980.91</u>

Since value in use exceeds fair value less costs to sell, value in use is selected to represent the recoverable amount of this cash-generating unit. This is lower than the carrying amount of the group of assets, however, and thus an impairment must be recognized as of the end of 20XX, in the amount of €123,000 – €91,981 = €31,019. This will be included in operating expenses (either depreciation or a separate caption in the statement of comprehensive income or in the statement of profit or loss, if prepared separately) for 20XX.

#### **Reversals of previously recognized impairments under historical cost method of accounting**

IFRS provides for recognition of reversals of previously recognized impairments. In order to recognize a recovery of a previously recognized impairment, a process similar to that

which led to the original loss recognition must be followed. This begins with consideration, at the end of each reporting period, of whether there are indicators of possible impairment recoveries, utilizing external and internal sources of information. Data relied upon could include that pertaining to material market value increases; changes in the technological, market, economic or legal environment or the market in which the asset is employed; and the occurrence of a favourable change in interest rates or required rates of return on assets which would imply changes in the discount rate used to compute value in use. Also to be given consideration are data about any changes in the manner in which the asset is employed, as well as evidence that the economic performance of the asset has exceeded expectations and/or is expected to do so in the future.

If one or more of these indicators is present, it will be necessary to compute the recoverable amount of the asset in question or, if appropriate, of the cash-generating unit containing that asset, in order to determine if the current recoverable amount exceeds the carrying amount of the asset, where it had been previously reduced for impairment.

If that is the case, a recovery can be recognized under IAS 36. The amount of recovery to be recognized is limited, however, to the difference between the carrying amount and the amount which would have been the current carrying amount had the earlier impairment not been given recognition. Note that this means that restoration of the full amount at which the asset was carried at the time of the earlier impairment cannot be made, since time has elapsed between these two events and further depreciation of the asset would have been recognized in the interim.

#### Example of impairment recovery

To illustrate, assume an asset had a carrying amount of €40,000 at December 31, 20XX-1 based on its original cost of €50,000, less accumulated depreciation representing the one-fifth, or two years, of its projected useful life of 10 years which already has elapsed. The carrying amount of €40,000 is after depreciation for 20XX-1 has been computed, but before impairment has been addressed. At that date, a determination was made that the asset's recoverable amount was only €32,000 (assume this was properly computed and that recognition of the impairment was warranted), so that an €8,000 adjustment must be made. For simplicity, assume this was added to accumulated depreciation, so that at December 31, 20XX-13, the asset cost remains €50,000 and accumulated depreciation is stated as €18,000.

At December 31, 20XX, before any adjustments are posted, the carrying amount of this asset is €32,000. Depreciation for 20XX would be €4,000 (= €32,000 carrying amount ÷ 8 years remaining life), which would leave a net carrying amount, after current period depreciation, of €28,000. However, a determination is made that the asset's recoverable amount at this date is €37,000. Before making an adjustment to reverse some or all of the impairment loss previously recognized, the carrying amount at December 31, 20XX, as it would have existed had the impairment not been recognized in 2013 must be computed.

December 31, 20XX-1 pre-impairment carrying amount	€40,000
20XX depreciation based on above	<u>5,000</u>
Indicated December 31, 20XX carrying value	<u>€35,000</u>

The December 31, 20XX carrying value would have been €40,000 – €5,000 = €35,000; this is the maximum carrying value which can be reflected in the December 31, 20XX statement of financial position. Thus, the full recovery cannot be recognized; instead, the 20XX statement of profit or loss will reflect (net) a *negative* depreciation charge of €35,000 – €32,000 = €3,000, which can be thought of (or recorded) as follows:

Actual December 31, 20XX-1 carrying amount	€32,000
20XX depreciation based on above	<u>4,000</u> (a)
Indicated December 31, 20XX carrying amount	€28,000
Actual December 31, 20XX carrying amount	<u>35,000</u>
Recovery of previously recognized impairment	<u>€ 7,000</u> (b)

Thus, the net effect in 20XX profit or loss is (a) – (b) = €(3,000). The asset cannot be restored to its indicated recoverable amount at December 31, 20XX, amounting to €37,000, as this exceeds the carrying amount that would have existed at this date had the impairment in 20XX-1 never been recognized.

Where a cash-generating unit including goodwill has been impaired, and the impairment has been allocated first to the goodwill and then pro rata to the other assets, *only* the amount allocated to non-goodwill assets can be reversed. The standard specifically prohibits the reversal of impairments to goodwill, on the basis that the goodwill could have been replaced by internally generated goodwill, which cannot be recognized under IFRS.

### ***Reversals of previously recognized impairments under revaluation method of accounting***

Reversals of impairments are accounted for differently if the reporting entity employed the revaluation method of accounting for long-lived assets. Under this approach, assets are periodically adjusted to reflect current fair values, with the write-up being recorded in the asset accounts and the corresponding credit reported in other comprehensive income and accumulated in the revaluation surplus in shareholders' equity, and not include in profit or loss. Impairments are viewed as being downward adjustments of fair value in this scenario, and accordingly are reported in other comprehensive income as reversals of previous revaluations (to the extent of any credit balance in the revaluation surplus for that asset) and not charged against profit unless the entire remaining, unamortized portion of the revaluation surplus is eliminated as a consequence of the impairment. Any further impairment is reported in profit or loss.

When an asset (or cash-generating group of assets) had first been revalued upward, then written down to reflect impairment, and then later adjusted to convey a recovery of the impairment, the required procedure is to report the recovery as a reversal of the impairment, as with the historical cost method of accounting for long-lived assets. Since in most instances impairments will have been accounted for as reversals of upward revaluations, a still-later reversal of the impairment will be seen as yet another upward revaluation and accounted for as a credit to other comprehensive income and cumulative amount in revaluation surplus in equity, not to be reported through profit or loss. In the event that impairment will have eliminated the entire revaluation surplus account, and an excess loss will have been charged against profit, then a later recovery will be reported in profit to the extent the earlier write-down had been so reported, with any balance recorded as a credit to other comprehensive income.

#### **Example of impairment recovery—revaluation method**

To illustrate, assume an asset was acquired January 1, 20XX-2, and it had a net carrying amount of €45,000 at December 31, 20XX-1, based on its original cost of €50,000, less accumulated depreciation representing the one-fifth, or two years, of its projected useful life of 10 years, which has already elapsed, plus a revaluation write-up of €5,000, net. The increase in carrying amount was recorded a year earlier, based on an appraisal showing the asset's then fair value was €56,250.



At December 31, 20XX, impairment is detected, and the recoverable amount at that date is determined to be €34,000. Had this not occurred, depreciation for 20XX would have been ( $€45,000 \div 8$  years remaining life =) €5,625; carrying amount after recording 20XX depreciation would have been ( $€45,000 - €5,625 =$ ) €39,375. Thus the impairment loss recognized in 20XX net amount of the previously recognized valuation increase remaining (i.e., undepreciated) at the end of 20XX, as shown below.

Gross amount of revaluation at December 31, 20XX-2	€6,250
Portion of the above allocable to accumulated depreciation	<u>625</u>
Net revaluation increase at December 31, 20XX-2	5,625
Depreciation taken on appreciation for 20XX-1	<u>625</u>
Net revaluation increase at December 31, 20XX-1	5,000
Depreciation taken on appreciation for 20XX	<u>625</u>
Net revaluation increase at December 31, 20XX, before recognition of impairment	4,375
Impairment recognized as reversal of earlier revaluation	<u>4,375</u>
Net revaluation increase at December 31, 20XX	<u>€ 0</u>

The remaining €1,000 impairment loss is recognized at December 31, 20XX, in profit or loss, since it exceeds the available amount of revaluation surplus.

In 20XX there is a recovery of value that pertains to this asset; at December 31, 20XX, it is valued at €36,500. This represents a €2,500 increase in carrying amount from the earlier year's balance, net of accumulated depreciation. The first €1,000 of this recovery in value is credited to profit, since this is the amount of previously recognized impairment that was charged against profit; the remaining €1,500 of recovery is accounted for as other comprehensive income and accumulated in the revaluation surplus in shareholders' equity.

**Deferred tax effects.** Recognition of an impairment for financial reporting purposes will most likely not be accompanied by a deduction for current tax purposes. As a consequence of the non-deductibility of most impairment charges, the carrying amount and tax basis of the impaired assets will diverge, with the difference thus created to gradually be eliminated over the remaining life of the asset, as depreciation for tax purposes varies from that which is recognized for financial reporting. Following the dictates of IAS 12, deferred taxes must be recognized for this new discrepancy. The accounting for deferred taxes is discussed in Chapter 26 and will not be addressed here.

#### ***Impairments that will be mitigated by recoveries or compensation from third parties***

Impairments of tangible long-lived assets may result from natural or other damages, such as from floods or windstorms, and in some such instances there will be the possibility that payments from third parties (typically commercial insurers) will mitigate the gross loss incurred. The question in such circumstances is whether the gross impairment must be recognized, or whether it may be offset by the actual or estimated amount of the recovery to be received by the reporting entity.

IAS 16 holds that when property is damaged or lost, impairments and claims for reimbursements should be accounted for separately (i.e., not netted for financial reporting purposes). Impairments are to be accounted for per IAS 36 as discussed above; disposals (of damaged or otherwise impaired assets) should be accounted for consistent with guidance in IAS 16. Compensation from third parties, which are gain contingencies, should be recognized as profit only when the funds become receivable. The cost of replacement items or of restored items is determined in accordance with IAS 16.

### ***Disclosure requirements***

For each class of property, plant and equipment, the amount of impairment losses recognized in profit or loss for each period being reported upon must be stated, with an indication of where in the statement of comprehensive income it has been presented (i.e., as part of depreciation or with other charges). For each class of asset, the amount of any reversals of previously recognized impairment must also be stipulated, again with an identification of where in the statement of comprehensive income that this has been presented. If any impairment losses were recognized in other comprehensive income and in revaluation surplus in equity (i.e., as a reversal of a previously recognized upward revaluation), this must be disclosed. Finally, any reversals of impairment losses that were recognized in other comprehensive income and in equity must be stated.

If the reporting entity is reporting financial information by segment (in accordance with IFRS 8 as discussed in more detail in Chapter 28), the amounts of impairments and of reversals of impairments, recognized in profit or loss and in other comprehensive income during the year for each reportable segment, must also be stated. Note that the segment disclosures pertaining to impairments need not be categorized by asset class, and the location of the charge or credit in the statement of profit or loss need not be stated (but will be understood from the disclosures relating to the primary financial statements themselves).

IAS 36 further provides that if an impairment loss for an individual asset or group of assets categorized as a cash-generating unit is either recognized or reversed during the period, in an amount that is material to the financial statements taken as a whole, disclosures should be made of the following:

- The events or circumstances that caused the loss or recovery of loss;
- The amount of the impairment loss recognized or reversed;
- If for an individual asset, the nature of the asset and the reportable segment to which it belongs, as defined under IFRS 8;
- If for a cash-generating unit, a description of that unit (e.g., defined as a product line, a plant, geographical area, etc.), the amount of impairment recognized or reversed by class of asset and by reportable segment based on the primary format, and, if the unit's composition has changed since the previous estimate of the unit's recoverable amount, a description of the reasons for such changes;
- Whether fair value less costs to sell or value in use was employed to compute the recoverable amount;
- If recoverable amount is fair value less costs to disposal, the basis used to determine it (e.g., whether by reference to active market prices or otherwise) and the fair value hierarchy in which the fair value measure falls, which additional disclosure for Levels 2 and 3 including the valuation method and key assumptions used; and
- If the recoverable amount is value in use, the discount rate(s) used in the current and prior period's estimate.

Furthermore, when impairments recognized or reversed in the current period are material in the aggregate, the reporting entity should provide a description of the main classes of assets affected by impairment losses or reversals of losses, as well as the main events and circumstances that caused recognition of losses or reversals. This information is not required to the extent that the disclosures above are given for individual assets or cash-generating units.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

**Accounting policy: Impairment of non-financial assets**

The group assesses annually whether there is any indication that any of its assets have been impaired. If such indication exists, the asset's recoverable amount is estimated and compared to its carrying value. Where it is impossible to estimate the recoverable amount of an individual asset, the Company estimates the recoverable amount of the smallest cash-generating unit to which the asset is allocated.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount an impairment loss is recognized immediately in profit or loss, unless the asset is carried at a revalued amount, in which case the impairment loss is recognized as revaluation decrease.

For goodwill, intangible assets that have an indefinite life, and intangible assets not yet available for use, the recoverable amount is estimated annually and at the end of each reporting period if there is an indication of impairment.

**Note: Goodwill and impairment**

IFRS3 B67

**Cost**

Opening cost at 1 January 20XX-1	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of a subsidiary	X
Opening cost at 1 January 20XX	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of a subsidiary	X
<b>Closing cost at 31 December 20XX</b>	<b>X</b>

**Goodwill and impairment**

IFRS3 B67

**Cost**

Opening cost at 1 January 20XX-1	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of a subsidiary	X
Opening cost at 1 January 20XX	X
Recognized on acquisition of a subsidiary	X
Derecognized on disposal of a subsidiary	X
<b>Closing cost at 31 December 20XX</b>	<b>X</b>

**Accumulated impairment**

Opening balance at 1 January 20XX-1	X
Impairment loss	X
Opening balance at 1 January 20XX	X
Impairment loss	X
<b>Closing balance at 31 December 20XX</b>	<b>X</b>

Opening carrying value at 1 January 20XX-1	X
Opening carrying value at 1 January 20XX	X
<b>Closing carrying value at 31 December 20XX</b>	<b>X</b>

The events and circumstances that led to the recognition of the impairment loss was the disposal of a chain of retail stores in the United Kingdom. No other class of assets was impaired other than goodwill. IAS36 p130 (a),(d)

[Describe the cash generating units/individual intangible assets of the group and which operating segment they belong to (if any), and whether any impairment losses were recognized or reversed during the period.] IAS36 p130 (a),(d)

The aggregation of assets for identifying the cash-generating unit has not changed since the prior year. IAS36 p130(d)

The recoverable amount of a cash-generating unit is its value in use. In calculating the value in use of the impaired reportable segment the group used a discount rate of X% (20XX-1: X%). IAS36 p130 (e).(g)

The carrying amount of goodwill allocated to each reportable segment is as follows: IAS36 p134(a)

	<b>20XX</b>			
	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>	<b>Total</b>
Home country	X	X	X	X
Other Countries	X	X	X	X
	<b>20XX-1</b>			
	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>	<b>Total</b>
Home country	X	X	X	X
Other Countries	X	X	X	X

Management has based its cash flow projections on cash flow forecasts covering a 5 year period. Cash flows after the 5 year period have been extrapolated based on the estimated growth rates disclosed below. These growth rates do not exceed the long-term average growth rate for the industry or market in which the group operates. Other key assumptions used in the cash flow projections are as follows: IAS36 p134(d)

	<b>Manufacture</b>	<b>Retail</b>	<b>Distribution</b>
Growth rates	X	X	X
Discount rates	X	X	X
Gross profit margins	X	X	X

Management has based their assumptions on past experience and external sources of information, such as industry sector reports and market expectations. IAS36 p134(d)

## **NON-CURRENT ASSETS HELD FOR SALE**

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As part of its ongoing efforts to converge IFRS with US GAAP, the IASB issued IFRS 5, *Concurrent Assets Held for Sale and Discontinued Operations*. This introduced new and substantially revised guidance for accounting for long-lived tangible (and other) assets that have been identified for disposal, as well as new requirements for the presentation and disclosure of discontinued operations.

In addition to this, IFRIC 17 was issued in January 2009 to address the accounting that should followed in such situations and provides that the assets involved must be measured at their fair value and any gains or losses taken to profit or loss. The Interpretation also provides guidance on the measurement of the dividend payable in that the dividend payable is measured at the fair value of the assets to be distributed. If the entity gives its owners a choice or receiving either a non-cash asset or a cash alternative, the entity should estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative. At the end of each reporting period and at the date of settlement, the entity is required to review and adjust the carrying amount of the dividend payable, with any changes in carrying amount of the dividend payable recognized in equity as adjustments to the amount of the distribution.

This approach differs from the previous approach, which permitted the recording of transactions that resulted in the distribution of non-monetary assets to owners of an entity in a spin-off or other form of reorganization or liquidation being accounted for based on their recorded amount. IFRS 5 states that where management has decided to sell an asset, or disposal group, these should be classified in the statement of financial positions as “held-for-sale” and should be measured at the lower of carrying amount or fair value less cost to sell. After reclassification, these assets will no longer be subject to systematic depreciation. The measurement basis for non-current assets classified as held-for-sale is to be applied to the group as a whole, and any resulting impairment loss will reduce the carrying amount of the non-current assets in the disposal group.

Assets and liabilities which are to be disposed of together in a single transaction are to be treated as a *disposal group*. In accordance with the standard, a disposal group is a group of assets (and liabilities directly associated with those assets) to be disposed of, by sale or otherwise, together as a group in a single transaction. Goodwill acquired in a business combination is included in the disposal group if this group is a cash-generating unit to which goodwill has been allocated in accordance with IAS 36 or if it is an operation within such a cash-generating unit.

#### ***Held-for-sale classification***

The reporting entity would classify a non-current asset (or disposal group) as held-for-sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. The criteria are as follows:

1. For an asset or disposal group to be classified as held-for-sale, the asset (or asset group) must be available for immediate sale in its present condition and its sale must be *highly probable*.
2. In addition, the asset (or disposal group) must be currently being marketed actively at a price that is reasonable in relation to its current fair value.
3. The sale should be completed, or expected to be so, within 12 months from the date of the classification. IFRS 5 does however allow for some exceptions to this principle, which are discussed below.
4. The actions required to complete the planned sale will have been made, and it is unlikely that the plan will be significantly changed or withdrawn. For this purpose, factors such as, for example, shareholders’ approval should be considered as part of the assessment of whether the sale is highly probable.
5. For the sale to be highly probable, management must be committed to selling the asset and must be actively looking for a buyer.

6. In the case that the sale may not be completed within 12 months, the asset could still be classified as held-for-sale if the delay is caused by events beyond the entity's control and the entity remains committed to selling the asset.

Extension of the period beyond 12 months is allowable in the following situations:

- The reporting entity has committed itself to sell an asset, and it expects that others may impose conditions on the transfer of the asset that could not be completed until after a firm purchase commitment has been made, and a firm purchase commitment is highly probable within a year.
- A firm purchase commitment is made but a buyer unexpectedly imposes conditions on the transfer of the asset held for sale; timely actions are being taken to respond to the conditions, and a favourable resolution is anticipated.
- During the one-year period, unforeseen circumstances arise that were considered unlikely, and the asset is not sold. Necessary action to respond to the change in circumstances should be taken. The asset should be actively marketed at a reasonable price and the other criteria set out for the asset to be classified as held-for-sale should have been met.

Occasionally companies acquire non-current assets exclusively with a view to disposal. In these cases, the non-current asset will be classified as held-for-sale at the date of the acquisition only if it is anticipated that it will be sold within the one-year period and it is highly probably that the held-for-sale criteria will be met within a short period of the acquisition date. This period normally will be no more than three months. Exchanges of non-current assets between companies can be treated as held-for-sale when such an exchange has commercial substance in accordance with IAS 16.

If the criteria for classifying a non-current asset as held-for-sale occur *after* the reporting date, the non-current asset should *not* be presented as held-for-sale. Nonetheless, certain information should be disclosed about these non-current assets.

Operations that are expected to be wound down or abandoned do not meet the definition of held for sale. However, a disposal group that is to be abandoned may meet the definition of a discontinued activity. *Abandonment* means that the non-current asset (disposal group) will be used to the end of its economic life, or the non-current asset (disposal group) will be closed rather than sold. The reasoning behind this is that the carrying amount of the non-current asset will be recovered principally through continued usage. A non-current asset that has been temporarily taken out of use or service cannot be classified as being abandoned.

### ***Measurement of non-current assets held for sale***

Assets that are classified as being held for disposal are measured differently and presented separately from other non-current assets. In accordance with IFRS 5, the following general principles would apply in measuring non-current assets that are held for sale:

- Just before an asset is initially classified as held-for-sale, it should be measured in accordance with the applicable IFRS.
- When non-current assets or disposal groups are classified as held-for-sale, they are measured at the *lower of the carrying amount and fair value less costs to sell*.
- When the sale is expected to occur in more than a year's time, the entity should measure the cost to sell at its present value. Any increase in the present value of the

cost to sell that arises from the passage of time should be shown in profit and loss as finance cost.

- Any impairment loss is recognized in profit or loss on any initial or subsequent write-down of the asset or disposal group to fair value less cost to sell.
- Any subsequent increases in fair value less cost to sell of an asset can be recognized in profit or loss to the extent that it is *not in excess of the cumulative impairment loss* that has been recognized in accordance with IFRS 5 (or previously in accordance with IAS 36).
- Any impairment loss recognized for a disposal group should be applied in the order set out in IAS 36.
- Non-current assets or disposal groups classified as held-for-sale should not be depreciated.

Any interest or expenses of a disposal group should continue to be provided for.

The standard stipulates that, for assets not previously revalued (under IAS 16), any recorded decrease in carrying amount (to fair value less cost to sell or value in use) would be an impairment loss taken as charge against income; subsequent changes in fair value would also be recognized, but not increases in excess of impairment losses previously recognized.

For an asset that is carried at a revalued amount (as permitted under IAS 16), revaluation under that standard will have to be effected immediately before it is reclassified as held-for-sale under this proposed standard, with any impairment loss recognized in profit or loss. Subsequent increases or decreases in estimated costs to sell the asset will be recognized in profit or loss. On the other hand, decreases in estimated fair value would be offset against revaluation surplus created under IAS 16, (recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus), and subsequent increases in fair value would be recognized in full as a revaluation increase under IAS 16, identical to the accounting required before the asset was reclassified as held-for-sale.

A disposal group, as defined under IFRS 5, may include some assets which had been accounted for by the revaluation method. For such disposal groups subsequent increases in fair value are to be recognized, but only to the extent that the carrying amounts of the non-current assets in the group, after the increase has been allocated, do not exceed their respective fair value less costs to sell. The increase recognized would continue to be treated as a revaluation increase under IAS 16.

Finally, IFRS 5 states that non-current assets classified as held-for-sale are not to be depreciated. This is logical: the concept objective of depreciation accounting is to allocate asset cost to its useful economic life, and once an asset is denoted as being held-for-sale, this purpose is no longer meaningful. The constraints on classifying an asset as held-for-sale are, in part, intended to prevent entities from employing such reclassification as a means of avoiding depreciation. Even after classification as held-for-sale, however, interest and other costs associated with the asset are still recognized as expenses as required under IFRS.

**Measurement of non-current assets held for distribution to owners.** Assets that are classified as being held for distribution to owners are measured differently and presented separately from other non-current assets. An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the lower of its carrying amount and fair value less costs to distribute.

### ***Change of plans***

If the asset held for sale or held for distribution to owners is not later disposed of or distributed, it is to be reclassified to the operating asset category it is properly assignable to. The amount to be initially recognized upon such reclassification would be the lower of:

1. The asset's carrying amount before the asset (or disposal group) was classified as held-for-sale, adjusted for any depreciation or amortization that would have been recognized during the interim had the asset (disposal group) not been classified as held-for-sale; and
2. The *recoverable amount* at the date of the subsequent decision not to sell.

If the asset is part of a cash-generating unit (as defined under IAS 36), its recoverable amount will be defined as the carrying amount that would have been recognized after the allocation of any impairment loss incurred from that same cash-generating unit.

Under the foregoing circumstance, the reporting entity would include, as part of income from continuing operations in the period in which the criteria for classification as held-for-sale or held for distribution to owners are no longer met, any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held-for-sale or held for distribution to owners. That adjustment would be presented in income from continuing operations. It is not an adjustment to prior period results of operations under any circumstances.

If an individual asset or liability is removed from a disposal group classified as held-for-sale or held for distribution to owners, the remaining assets and liabilities of the disposal group still to be sold will continue to be measured as a group only if the group meets the criteria for categorization as held-for-sale or held for distribution to owners. In other circumstances, the remaining non-current assets of the group that individually meet the criteria to be classified as held-for-sale or held for distribution to owners will need to be measured individually at the lower of their carrying amounts or fair values less costs to sell at that date.

If an entity reclassifies an asset (or disposal group) directly from being held for sale to being held for distribution to owners, or directly from being held for distribution to owners to being held for sale, then the change in classification is considered a continuation of the original plan of disposal. The guidance above for a change will not apply. The entity shall, however, apply the classification, presentation and measurement requirements in IFRS 5 that are applicable to the changed method of disposal. Any reduction or increase in the fair value less costs to sell/costs to distribute of the non-current asset (or disposal group) shall be recognized by following the normal measurement guidance for non-current assets held-for-sale or held for distribution to owners. The date of the original classification will not be changed. This does not preclude the application of the conditions for an extension of the period required to complete a sale or a distribution to owners.

### ***Presentation and disclosure***

IFRS 5 specifies that non-current assets classified as held-for-sale and the assets of disposal group classified as held-for-sale must be presented separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held-for-sale are also presented separately from other liabilities in the statement of financial position.

Several disclosures are required, including a description of the non-current assets of a disposal group, a description of the facts and circumstances of the sale, and the expected



manner and timing of that disposal. Any gain or loss recognized for impairment or any subsequent increase in the fair value less costs to sell should also be shown in the applicable segment in which the non-current assets or disposal group is presented in accordance with IFRS 8 (Chapter 28).

The disclosure requirements in other IFRS do not apply to such assets (or disposal groups) unless those IFRS require:

1. Specific disclosures in respect of non-current assets (or disposal groups) classified as held-for-sale or discontinued operations; or
2. Disclosures about measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of IFRS 5 and such disclosures are not already provided in the other notes to the financial statements.

Where additional disclosures about non-current assets (or disposal groups) classified as held-for-sale or discontinued operations are necessary in order to comply with the general requirements of IAS 1, then such disclosures must still be made.

## **DISCONTINUED OPERATIONS**

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### ***Presentation and disclosure***

IFRS requires an entity to present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations. A *discontinued operation* is a part of an entity that has either been disposed of or is classified as held-for-sale and meets the following requirements:

1. Represents a separate major line of business or geographical area of operations;
2. Is part of a single coordinated plan to dispose of separate major line of business or geographical area of operations; or
3. Is a subsidiary acquired exclusively with a view to resale.

An entity should present in the statement of comprehensive income a single amount comprising the total of:

- The after-tax profit or loss of discontinued operations; and
- The after-tax gain or loss recognized on the measurement to fair value less costs to sell (or on the disposal) of the assets or disposal groups classified as discontinued operations.

IFRS 5 requires detailed disclosure of revenue, expenses, pre-tax profit or loss, and the related income tax expense, either in the notes or on the face of the statement of comprehensive income. If this information is presented on the face of the statement of comprehensive income (or separate statement of profit or loss if the two-statement alternative is used), the information should be separately disclosed from information relating to continuing operations. Regarding the presentation in the statement of cash flows, the net cash flows attributable to the operating, investing and financing activities of the discontinued operation should be shown separately on the face of the statement or disclosed in the notes.

Any disclosures should cover both the current and all prior periods that have been shown in the financial statements. Retrospective classification as a discontinued operation, where

the criteria are met after the statement of financial position date, is prohibited by IFRS. In addition, adjustments made in the current accounting period to amounts that have previously been disclosed as discontinued operations from prior periods must be separately disclosed. If an entity ceases to classify a component as held-for-sale, the results of that element must be reclassified and included in the results from continuing operations.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

<b>Exemplum Reporting PLC</b>				
<b>Financial statements</b>				
<b>For the year ended 31 December 20XX</b>				
<b>Profit for the period from continuing operations</b>		<b>X</b>	<b>X</b>	
				IAS1 p82 IFRS5 p33
Profit for the year from discontinued operations	12	<u><b>X</b></u>	<u><b>X</b></u>	
<b>PROFIT FOR THE YEAR</b>		<u><u><b>X</b></u></u>	<u><u><b>X</b></u></u>	
<b>Earnings per share</b>				
<b>From continuing operations</b>	13	<b>X</b>	<b>X</b>	IAS33 p66
Basic (cents per share)	13	<b>X</b>	<b>X</b>	
Diluted (cents per share)		<u><u><b>X</b></u></u>	<u><u><b>X</b></u></u>	
<b>From continuing and discontinued operations</b>	13	<b>X</b>	<b>X</b>	IAS33 p68
Basic (cents per share)	13	<b>X</b>	<b>X</b>	
Diluted (cents per share)		<u><u><b>X</b></u></u>	<u><u><b>X</b></u></u>	

### 12. Discontinued operations

#### 12.1 Analysis of the statement of comprehensive income result:

In May 20XX the management committed to dispose of the packaging division. The sale is expected to be concluded in February 20XX, and no further loss is expected on the disposal of the assets involved. The packaging division fell within the distribution reporting segment.

	<b>20XX</b>	<b>20XX-1</b>	
Analysis of cash flow movements			IFRS5 p33(c)
Operating cash flows	<b>X</b>	-	
Investing cash flows	<b>X</b>	-	
Financing cash flows	<b>X</b>	-	
Total cash flows	<u><u><b>X</b></u></u>	<u><u><b>X</b></u></u>	
	<b>20XX</b>	<b>20XX-1</b>	
Analysis of statement of comprehensive income result			IFRS5 p33(c)
Revenue	<b>X</b>	<b>X</b>	
Expenses	<u><b>X</b></u>	<u><b>X</b></u>	
Loss before tax of discontinued operations	<b>X</b>	<b>X</b>	
Income tax expense	<u><b>X</b></u>	<u><b>X</b></u>	
Loss after tax of discontinued operations	<b>X</b>	<b>X</b>	

Pre-tax loss recognized on the measurement to fair value	X	-
Income tax expenses	X	-
After-tax loss recognized on the measurement to fair value	X	-
Loss for the year from discontinued operations	X	X

**12.2 Analysis of assets and liabilities:**

Cumulative income or expense recognized directly in other comprehensive income:	<b>20XX</b>	20XX-1	IFRS5 p38
Foreign exchange translation adjustments	X	-	
	X	-	
Analysis of assets and liabilities	<b>20XX</b>	20XX-1	IFRS5 p38
Property, plant and equipment	X	-	
Goodwill	X	-	
Inventory	X	-	
Other current assets	X	-	
	X	-	
Other current liabilities	X	-	
Current-provisions	X	-	
	X	-	

**US GAAP COMPARISON**

Impairment under US GAAP is a three-step process. The first step, sometimes referred to as step zero, is an optional qualitative assessment as to the likelihood of an impairment. An entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. If it is determined that it is likely that the long-lived asset is impaired, then the entity must proceed to the quantitative step. An entity may skip the qualitative assessment and proceed with the quantitative steps.

The first quantitative step is to compare the undiscounted future cash flows, termed the recoverable amount, of the assets being tested to the carrying value. If the recoverable amount is less than the carrying value, the second step is taken, resulting in a write-down of the excess of the fair value of the asset over the carrying value. Impairments cannot be reversed.

The previous differences between IFRSs and US GAAP in the definition, and hence the accounting, of discontinued operations were largely removed by ASC 205-20-45-1B.

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## INTRODUCTION

In May 2011 the IASB simultaneously issued three new standards and two amended standards. This so-called “suite of five” covers all aspects of group accounting and consolidation, joint arrangements, equity accounting and related disclosure of interests in other entities. Disclosure of unconsolidated structured entities is also addressed for the first time in the history of IFRS. The new standards and the replaced standards are:

New IFRS	Replaced IFRS
IFRS 10, <i>Consolidated Financial Statements</i> .	IAS 27, <i>Consolidated and Separate Financial Statements</i> , and SIC-12, <i>Consolidation Special Purpose Entities</i> .
IFRS 11, <i>Joint Ventures</i> .	IAS 31, <i>Interest in Joint Ventures</i> , and SIC 13, <i>Jointly Controlled Entities—Non-monetary Contributions by Venturers</i> .
IFRS 12, <i>Disclosure of Interest in Other Entities</i> .	None. Previously the disclosure requirements relating to interests in other entities were contained in each separate standard.
IAS 27, <i>Separate Financial Statements</i> .	IAS 27, <i>Consolidated and Separate Financial Statements</i> .
IAS 28, <i>Investments in Associates and Joint Ventures</i> .	IAS 28, <i>Investment in Associates</i> , and IAS 31, <i>Interests in Joint Ventures</i> .

IFRS 10, *Consolidated Financial Statements*, establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities, and introduces a single model for identifying control to replace the previous concepts of control contained within the former IAS 27 and SIC-12. IFRS 11, *Joint Arrangements*, establishes principles for the financial reporting by parties to a joint arrangement. The option to proportionately consolidate joint ventures that was previously available to jointly controlled entities under IAS 31 has been eliminated. IFRS 12, *Disclosure of Interest in Other Entities*, combines, enhances, and replaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities. IAS 27 (revised) deals with the presentation of separate financial statements. IAS 28 (revised) identifies associates and deals with equity accounting for both associates and joint ventures.

## DEFINITIONS OF TERMS

**Associate.** An entity over which an investor has significant influence.

**Consolidated financial statements.** Financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

**Control of an investee.** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

**Decision maker.** An entity with decision-making rights that is either a principal or an agent of the principal.

**Equity method.** A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

**Group.** A parent and its subsidiaries.

**Interest in another entity.** An interest in another entity refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity.

**Investment entity.** An entity that obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and measures and evaluates the performance of substantially all of its investments on a fair value basis.

**Joint arrangement.** An arrangement of which two or more parties have joint control.

**Joint control.** The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

**Joint operation.** A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

**Joint operator.** A party to a joint operation that has joint control of the operation.

**Joint venture.** A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

**Joint venturer.** A party to a joint venture that has joint control of the joint venture.

**Non-controlling interest.** Equity in a subsidiary not attributable, directly or indirectly, to the parent.

**Parent.** An entity that controls one or more entities.

**Party to a joint arrangement.** An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

**Power.** Existing rights that give the current ability to direct the relevant activities.

**Protective rights.** Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

**Public market.** Public market includes a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets.

**Relevant activities.** Activities of the investee that significantly affect the investee's returns.

**Removal rights.** Rights to deprive the decision maker of its decision-making power.

**Separate financial statements.** Financial statements presented by an entity in which the entity could elect to account for its investment in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9, *Financial Instruments* (or IAS 39, *Financial Instruments: Recognition and Measurement*) or using the equity method as described in IAS 28, *Investments in Associates and Joint Ventures*.

**Separate vehicle.** A separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality.

**Significant influence.** The power to participate in the financial and operating policy decisions of the investee but it is not control or joint control of those policies.

**Structured entity.** An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

**Subsidiary.** An entity that is controlled by another entity.

## CONSOLIDATED FINANCIAL STATEMENTS

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### Scope

IAS 27 (2008) defined control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities,” whereas SIC-12 considered both benefits and risks in its assessment of control of special-purpose entities. This subtle but important difference in concepts led to inconsistent application of the principles in practice. IFRS 10 provides a revised definition of control and establishes control as the basis for consolidation, so that a single control model can be applied to all entities.

IFRS 10 sets out related guidance to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee. IFRS 10 also sets out the accounting requirements for the preparation of consolidated financial statements.

IFRS 10 requires that an entity that is a parent must present consolidated financial statements that include all subsidiaries of the parent. Only three exceptions to this rule are available. Firstly, a parent need not present consolidated financial statements if all the following criteria are met:

- The parent itself is a wholly-owned subsidiary or it is a partially-owned subsidiary of another entity and all of its owners, including those not normally entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- Its debt and equity instruments are not traded in a public market;
- It did not file, nor is it in the process of filing, its financial statements with a securities exchange commission or other regulatory organization for the purpose of issuing any class of its instruments in a public market; and
- Its ultimate or intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS.

Secondly, post-employment benefit plans or other long-term employee benefits plans to which IAS 19, *Employee Benefits*, apply are also excluded from the scope of IFRS 10.

Thirdly, an investment entity need not present consolidated financial statements if it is required to measure those subsidiaries at fair value through profit or loss in accordance with IFRS 9, *Financial Instruments* (or IAS 39, *Financial Instruments: Recognition and Measurement* until IFRS 9 comes into effect). Investment entities are discussed later in this chapter.

### ***Identification of a subsidiary***

Under IFRS 10 an investor shall determine if it is a parent by assessing whether it controls the investee. A subsidiary is defined as “an entity that is controlled by another entity” (IFRS 10 App A). An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. The definition contains three requirements that must be present in order for control to exist:

- Power over the investee;
- Exposure, or rights, to variable returns; and
- The ability to use the power over the investee to affect the amount of returns.

The three requirements are interrelated. The ability to use power to affect the returns creates a link between the first two requirements. Only when the power could be used to affect the returns, is the definition of control met. An investor must assess all facts and circumstances to determine whether it controls an entity. Paragraph B3 of Appendix B to IFRS 10 contains the following factors investors should use in order to determine if the control a subsidiary: (1) the purpose and design of the investee; (2) what the relevant activities are; (3) how decisions about those activities are made; (4) whether the rights of the investors give it the current ability to direct the relevant activities; (5) whether the investor is exposed, or has the rights to variable returns from its involvement with the investee; and (6) whether the investor has the ability to use its power over the investee to affect the amount of the investor’s return.

These facts and circumstances should be continuously monitored, and if there are any changes to the facts or circumstances, control should be reassessed.

### ***Power***

Regarding the first requirement, an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities that significantly affect the investee’s returns. Returns will only be affected if the investor can control the activities that generate the returns.

Examples of activities that could, depending on the circumstances, be principal activities include: the purchase and sale of goods or services, the selection, acquisition or sale of assets, research and development for new products or procedures, and the establishment of finance structures or the procurement of funds. If two or more investors currently have the ability to manage the principal activities and these activities take place at different times, the investors must determine which of them has the ability to manage those activities that have the greatest effect on these returns.

#### **Example of more than one investor**

Two investors agree to form an entity to develop and market a new product. The one investor has unilateral decision-making power regarding the research and development of the product and the other has unilateral decision-making power regarding the manufacture and sale of the product.

To determine whether one or any of the investors controls the entity, the ability to direct the relevant activities must be assessed. This is achieved by first clarifying which activities are actually classified as relevant. If all activities—i.e., development as well as production and marketing—are relevant, each investor must determine whether he has the ability to direct the activities that most significantly affect the entity's returns.

Power arises from rights, and could arise in any of the following circumstances: (1) rights in the form of voting rights (or potential voting rights) of an investee; (2) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities; (3) rights to appoint or remove another entity that directs the relevant activities; (4) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and (5) other rights that give the holder the ability to direct the relevant activities. The lower one moves down this hierarchy, the more complex the assessment becomes. In the assessment, all the rights of others must be considered. An investor assessing whether he has decision-making power is only assessing substantive rights. Consequently, an investor that only holds protective rights does not have the power to direct the activities. A right is substantive when the holder has the practical ability to exercise the right. This requires judgement, taking into account all facts and circumstances. The following factors can be used in the assessment:

- Whether there are barriers (economic or otherwise) that prevent the holder from exercising the rights.
- Financial penalties and incentives that would prevent (or deter) the holder from exercising the rights.
- Terms and conditions that make it unlikely that the rights would be exercised.
- The absence of an explicit, reasonable mechanism in the founding documents of an investee or in the applicable laws or regulations that would allow the holder to exercise the rights.
- The inability of the holder of the rights to obtain the information necessary to exercise the rights.
- Operational barriers or incentives that would prevent the holder from exercising the rights.
- Legal or regulatory requirements that prevent the holder from exercising the rights.

Usually the substantive rights need to be exercisable when the decision regarding the direction of the relevant activities needs to be made. Rights may, however, also be of a substantial nature even if they cannot be exercised at present. An example for rights, which are currently not exercisable but are even then substantive is shown later in this chapter.

### ***Majority of voting rights***

Control is presumed if the majority of voting rights is held, unless other factors indicate that the majority of voting rights does not create control. Holding the majority of voting rights normally results in control if:

- The relevant activities are directed by the vote of the majority holder; or
- The holder of the majority of voting rights may appoint the majority of members of the governing body that directs the activities (for example, the board of directors).



For a majority of voting rights to result in control, those rights must be substantive. If another party, which is not an agent, has existing rights that provide the other party with the ability to direct the operating activities, the majority of voting rights presumption is rebutted. The test is to determine who has power over the activities.

#### **Example of majority of voting rights**

Investor B has a 51% interest in an investment vehicle (T). B is only a passive investor and is not involved in the decision-making process.

Since investor B is passive, the rights of others must be considered to determine if they have power to direct the activities. In the absence of other facts and circumstances, the assumption is that B will exercise his voting rights to prevent resolutions being adopted that are not in his interests. As such, B currently has the power to direct relevant activities, even though he may not have exercised that power in the past. B must therefore consolidate T.

#### ***Less than a majority of voting rights***

Control could also exist when a party has less than a majority of voting rights. The following are examples of instances where control could exist even though less than a majority of voting rights is held:

- A contractual arrangement between the investor and other parties that provides the investor with a right to direct the relevant activities.
- Rights arising from other contractual arrangements. Other decision-making rights together with voting rights might provide the party with the right to direct the relevant activities.
- The extent of the investor's voting rights. Although an investor may not hold the majority of the voting rights, the rights that are held could be so significant as to give it power to have the practical ability to direct the relevant activities unilaterally. This is referred to as *de facto* control.
- The investor may hold potential voting rights that are substantive. Potential voting rights are rights to obtain voting rights of an investee, such as convertible instruments and options. To be substantive, potential voting rights needs to be exercisable when decisions about the direction of the relevant activities need to be made. Usually they must be presently exercisable in order to be classified as substantial, although sometimes rights may be substantial even if they cannot be exercised at present. Example: An investor is the contracting partner in a forward contract for the acquisition of a majority holding in the associate company. The settlement value of the forward contract is due within 25 days. The existing shareholders cannot change the company's current policy with regard to its principal activities because extraordinary general meetings cannot be held in less than 30 days, at which time the forward contract will already have been fulfilled. By virtue of his possession of the forward contract, the investor is in a position to make decisions on the management of those principal activities. The investor's forward contract is a substantive right that gives him the ability to manage those principal activities now, before the forward contract is fulfilled.

Any combination of the above scenarios could result in an investor having control of an investee. In assessing *de facto* control, the size of the investor's holdings relative to size and

dispersion of other investors are considered, together with the other considerations listed above.

#### Examples of less than a majority of voting rights

**Example 1:** Investor A holds 45% of an entity's voting rights and no other investor holds more than 3%. De facto control might be present if no other consideration indicates that investor A has control, because the absolute size of his stake and the relative size of the other shareholdings indicate that A holds a sufficiently dominant share of the voting rights.

**Example 2:** Investor B holds 48% of an entity's voting rights and the other two investors hold 28% and 24% respectively. Beyond that, no other agreements exist that might influence the adoption of resolutions. The size of the other investors' rights indicates that investor B does not hold de facto control. The other two investors only need to join forces to prevent investor B from directing the relevant activities of the joint venture.

#### *Exposure, or rights, to variable returns from an investee*

An investor is exposed, or has rights to, variable returns when the investor's returns from the involvement have the potential to vary as a result of the investor's performance, whether negative or positive. Variable returns can arise in various forms, for example:

- Dividends or other distributions of economic benefits from an investee and changes in the value of the investment.
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits, and access to future liquidity that an investor has from its involvement with an investee.
- Returns that are not available to other interest holders. For example, combining operating functions to achieve economies of scale, cost savings, sourcing scarce products, gaining access to proprietary knowledge or limiting some operations or assets, to enhance the value of the investor's other assets.

#### *Link between power and returns*

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's return from its involvement with the investee. Therefore it is important to determine whether the investor is acting as an agent or the principal. If the investor acts as an agent, the investor does not control the investee. The investor will have been delegated power on behalf of another party or parties. An agent is a party primarily engaged to act on behalf or for the benefit of another party or parties (the principal). A decision maker must consider the overall relationship between itself, the investee being managed, and other parties involved with the investee, and in particular the following factors to determine whether the decision maker is acting as an agent or principal:

- The scope of the decision-making authority. This is directly linked to the activities the decision maker can control. The scope is evaluated by considering (1) the activities that are permitted according to the decision-making-agreement(s) and specified by law, and (2) the discretion that the decision maker has when making decisions about those activities. If, for example, a decision maker has a significant share in shaping the

associate company (in determining the extent of decision-making authorities, for example), this may indicate that he has the opportunity and incentive to acquire rights that confer on the decision maker the ability to manage its principal activities.

- The rights held by other parties. Substantive removal or other rights may indicate that the person is only acting as an agent, since these rights could remove the power. Rights of others might restrict the decision-making power or discretion.
- Remuneration to which the decision maker is entitled in accordance with any remuneration agreement(s). In making this assessment, it is necessary to consider whether the remuneration is commensurate with the service rendered and whether the remuneration contract is based on similar arm's-length transactions. A full arm's-length remuneration contract in which the decision maker is compensated for services rendered would ordinarily indicate that the decision maker is acting as an agent.
- The decision maker's exposure to variability of returns from other interests that it holds in the investee. Holding an interest in an entity with variable returns might indicate that the decision maker is a principal. Based on the last two criteria, the more variable the returns are in relation to determining remuneration, the more likely that the decision maker is a principal. Example: A decision maker founds, markets and manages a fund offering investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the interests of all investors and in accordance with the contracts that are most important to the fund. Nonetheless, the fund manager has a great deal of discretion where his decisions are concerned. For his services he receives a fee at the normal market level of 1% of assets under management plus 20% of the gains made by the fund once a specified level is reached. The fee is in reasonable proportion to the services provided.

Solution: Although the fund manager must make decisions in the interests of all investors, he enjoys wide decision-making authority in the management of the fund's principal activities. The fund manager receives fixed and variable fees at standard market levels. In addition, his remuneration has the effect of aligning the interests of fund managers and those of other investors in a rise in the fund's value. However, this imposes no risk arising from fluctuating returns from fund activities of such a magnitude that the remuneration, when viewed in isolation, might be seen as an indicator that the fund manager is the principal.

### ***Other arrangements***

Control can also exist through other contractual arrangements. This would usually be the case with structured entities. A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. The assessment of control in such instances is based on the normal principles discussed above as well as an assessment of the special arrangements and the size of the exposure regarding the variability in returns. In assessing the purpose and design, the risk that was created and passed on to the parties the arrangement is considered to establish the party's exposure to some or all of the risks. A large exposure to variability in returns might also indicate that the party has power over the entity. Such risk and returns are, however, on their own not conclusive. All facts and circumstances must be considered.

The involvement of the parties and decisions made at the inception of the arrangement are considered to determine whether the transaction terms and features provide the investor with rights that are sufficient to create control. Both explicit and implicit decision-making rights embedded in the contractual arrangement that are closely linked to the investor must be considered. Further contractual rights such as call rights, put rights and liquidation rights are also considered.

### **Consolidation Procedures**

Consolidated financial statements shall present fairly the financial position, financial performance and cash flows of the group (IAS 1.15). IFRS 10 contains only a little guidance on the preparation of consolidated financial statements (IFRS 10 B86–B93). A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances. Consolidation begins from the date the investor obtains control and ceases when the investor loses control.

### ***Intercompany transactions and balances***

In preparing consolidated financial statements an entity combines the items presented in the financial statements line by line, adding together like items of assets, liabilities, equity, income and expenses. In order to present financial information about the group as that of a single economic entity, the following procedures are followed:

- Like items of assets, liabilities, equity, income, expenses and cash flows of the parent are combined with those of the subsidiary.
- The carrying amount of the parent's investment in each subsidiary is eliminated (offset) against the parent's portion of equity of each subsidiary.
- Intragroup assets, and liabilities, equity, income, expenses and cash flows relating to transactions of the entities in the group are eliminated. For example, a parent may sell merchandise to its subsidiary, at cost or with a profit margin added, before the subsidiary ultimately sells the merchandise to unrelated parties in arm's-length transactions. Furthermore, any balances due to or from members of the consolidated group at the end of the reporting period must also be eliminated. If assets have been transferred among the entities in the controlled group at amounts in excess of the transferor's cost, and they have not yet been further transferred to outside parties (e.g., inventories) or not yet consumed (e.g., plant assets subject to depreciation) by the end of the reporting period, the amount of profit not yet realized through an arm's-length transaction must be eliminated.

### ***Non-controlling interests***

When less than 100% of the shares of the acquired entity are owned by the acquirer, a complication arises in the preparation of consolidated statements, and a non-controlling interest must be determined and presented. According to IFRS 10.22 non-controlling interests must be presented in the consolidated statement of financial position within equity, separately from the equity of controlling interests (the owners of the parent). If a company holds non-controlling interests in several subsidiaries, the various non-controlling interests can be reported within a single position. This method complies with the economic unit concept that is employed in the world of Anglo-Saxon accounting. The profit or loss and each component of other comprehensive income to the owners of the parent and to the

non-controlling interests must be attributed separately. This applies even if this allocation brings about a situation in which the non-controlling interests post or will in future post a negative equity balance. Not even the non-existence of an additional-funding obligation on the part of the non-controlling interests makes any difference to this allocation. In this event a negative share of the non-controlling interests must consequently be reported within equity.

The control concept of IFRS 10 and the economic unit concept can jointly lead to a situation where a parent company, even though it has a minority holding in an entity, controls the relevant activities of the subsidiary – by virtue of other agreements, for example – and hence also controls the subsidiary itself. Since shares in the equity and the profit or loss are determined on the basis of ownership interest (for which see below), this leads to a situation in which consolidation includes 100% of an entity's assets and liabilities while the majority of the equity must be allocated to non-controlling interests. In these cases IFRS 12 requires the disclosure of the nature of the relationship between a parent and a subsidiary when less than 50% of voting rights are owned.

Measurement of non-controlling interests. According to IFRS 3.10 entities have the choice to measure the non-controlling interests at either fair value or at its proportionate share in the recognized amounts of the acquiree's identifiable net assets. This choice can be made on a transaction-by-transaction basis. It is not required for entities to make an accounting policy choice. In the subsequent periods the non-controlling interest is not remeasured to fair value. But, the share of the profit or loss and each component of other comprehensive income is allocated to non-controlling interests as described above.

### *Changes in the proportion of non-controlling interests*

In the consolidated statement of financial position non-controlling interest is presented within equity, separately from the equity of the owners of the parent. Changes in a parent's interest in a subsidiary that do not result in the parent losing control are equity transactions and result in transfers to and from the owner's equity to non-controlling interest. The difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognized directly in equity attributable to the parent.

#### **Example of recognizing changes in the level of the parent's controlling ownership interest**

Konin Corporation (KC) owns a 75% interest in Donna Corporation (DC). KC decided to acquire an additional 10% interest in DC from the non-controlling shareholders in exchange for cash of €100,000. DC has net assets of €800,000. KC accounts for this transaction in the consolidated financial statements as follows:

Equity—Non-controlling interest	80,000	
Equity—Controlling interest	20,000	
Cash		100,000

Profit or loss and each component of other comprehensive income must be allocated to the owners of the parent and non-controlling interest. The total comprehensive income must also be allocated, even if this result in non-controlling interest having a deficit balance.

Non-controlling interests in the net assets consists of (1) the amount recognized at the date of the original business combination (calculated in accordance with IFRS 3[R]), and (2) the non-controlling interests' share of changes in equity (net assets) of the subsidiary since the date of combination.

### ***Uniformity of accounting policies***

There is a presumption that all the members of the consolidated group should use the same accounting principles to account for similar events and transactions. However, in many cases this will not occur, as, for example, when a subsidiary is acquired that uses cost for investment property while the parent has long employed the fair value method. IFRS 10 requires that the policies of the combining entities should be uniform and therefore appropriate adjustments should be made in the consolidated accounts. When a subsidiary of a corporate group is acquired and different accounting policies exist, the principles of IAS 8 permit the subsidiary to alter its accounting policy to that of the group in its individual financial statements. Alternatively the subsidiary may retain its previous principles in its individual financial statements. In this event the group should make appropriate adjustments in the consolidated accounts.

### ***Measurement***

Income and expenses of the subsidiary are included in the consolidated financial statements from the date control is obtained until the date when control is lost. The income and expenses are based on the amounts of assets and liabilities recognized at the acquisition date. The depreciation charges entered in the consolidated income statement after the date of acquisition, for example, are based on the fair value of the associated depreciable assets reported in the consolidated financial statements on the date of acquisition.

### ***Reporting date***

A practical consideration in preparing consolidated financial statements is to have information on all constituent entities current as of the parent's year-end. If a subsidiary has a different reporting date, the subsidiary prepares additional financial information as of the date of the consolidated financial statements to enable the parent to consolidate the subsidiary, unless it is impractical to do so.

If it is impractical, the subsidiary is consolidated using the most recent financial statements of the subsidiary adjusted for the effect of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. The difference between the date of the subsidiary's financial statements and the consolidated financial statements is limited to three months and must be applied consistently from period to period. Of course, if this option is elected, the process of eliminating intercompany transaction and balances may become a bit more complicated, since reciprocal accounts (e.g., sales and cost of sales) will be out of balance for any events occurring after the earlier fiscal year-end but before the later one.

### ***Ownership interest***

In the preparation of consolidated financial statements there is usually a question mark over the share of the profit or loss or changes in the equity of the subsidiary that the parent company must take into account in the preparation of its own consolidated financial statements if, for example, potential voting rights or non-controlling interests exist. IFRS 10 B 89 determines that the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests, unless an entity has, in

substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the return associated with an ownership interest.

#### Example

X has a 70% holding in Y and a 20% holding in Z. Y, in its turn, has a 35% holding in Z. Solution: X controls Y and thus also Z, because X directly and indirectly holds 55% of its shares. Y's holding in Z must be allocated in full to X, as X controls Y. Y and Z must consequently be included in X's consolidated financial statements. X's share of Y's profit or loss or changes in equity is 44.5% (20% + (70% of 35%)). X consequently allocates 55.5% of its subsidiary Y to non-controlling interests.

#### Indirect interest

If a parent company has an indirect holding, the treatment of the non-controlling interests is more complicated than in a single-tiered group. Furthermore, the amount of potential goodwill to be reported is contentious. The non-controlling interests in the parent company's consolidated financial statements are calculated by multiplying the fractions applying to the various tiers of the group. The calculation for the purposes of consolidation can be carried out either in a single step, or first at the level of the indirect holding, then at that of the parent company with a corresponding adjustment of the indirect holding (multi-tier consolidation).

#### Example

Parent company P holds 85% of the equity of its subsidiary S1 (400 monetary units (MUs)). S1 holds 75% of the equity of second-tier subsidiary S2 (100 MUs).

From P's viewpoint the non-controlling interest in S1 must be taken into account first: 15% of 400 MUs = 60 MUs. The indirect holding of non-controlling shareholder S1 in S2 is determined by multiplication: 15% of 75% of 100 MUs = 11.25 MUs. Finally the non-controlling shareholder's direct holding in S2 is included: 25% of 100 MUs = 25 MUs. A non-controlling interest total of 96.25 MUs must therefore be reported in P's consolidated financial statements.

If goodwill was revealed in the first consolidation of S2 in S1 in the revaluation process, the question arises as to the level of goodwill that must be included in P's consolidated financial statements.

#### Example

Modified example: S2 was also found to have goodwill of 30 MUs (in S1's subgroup financial statements). S2's equity is thus 130 MUs. The interests of non-controlling shareholders in S2 remain unchanged at 25 MUs, as goodwill is basically only allocated to the acquirer (S1).

The treatment of goodwill at the level of P is contentious. On the one hand it is contended that here, too, goodwill should be reported at 30 MUs, and that the non-controlling interest is accordingly 4.5 MUs higher (30 MUs x 15%). This is argued on the grounds that non-controlling shareholders in S1 were part of the S2 acquisition transaction.

The second view is based on net assets from the viewpoint of the group. This holds that P holds only 85% of the goodwill and may thus report only 25.5 MUs, while the remaining 4.5 MUs are offset against the non-controlling interest, restoring this to the amount in the original example.

We prefer the second view, because this reflects the goodwill commercially acquired by the group shareholders at its correct level. Also this does not result in any blending with the full goodwill method as in the first view. If the full goodwill method is applied as per IFRS 3.19, accounting is unambiguous. At the level of S1, goodwill of 40 MUs is detected (full goodwill = 30 MUs (S1 goodwill)/75%). Of this, 10 MUs are allocated to S2's non-controlling shareholders and 4.5 MUs to those of S1. In total, non-controlling interests of 110.75 MUs (equity share of 96.25 MUs plus 14.5 as a share of goodwill) must be reported in P's consolidated financial statements.

### ***Subsidiaries to be disposed of or acquired with a view to resale***

Subsidiaries that were acquired with a view to resale or are to be sold, where these meet the definition of an asset held for sale in accordance with IFRS 5, are not excluded from the consolidation. They must continue to be consolidated, and furthermore their results, assets and liabilities must be reported separately. These subsidiaries are presented in a single amount in the statement of comprehensive income comprising the total of:

- The post-tax profit or loss of discontinued operations; and
- The post-tax gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

The assets of the subsidiaries classified as held-for-sale must be separately from other assets in the statement of financial position. The same for the liabilities of the subsidiaries classified as held-for-sale.

The provisions of IFRS 5 are dealt with in detail in Chapter 13.

### ***Changes in ownership interest resulting in loss of control***

If a parent company ceases to have a controlling financial interest in a subsidiary, the parent is required to deconsolidate the subsidiary as of the date on which its control ceased. Examples of situations that can result in a parent being required to deconsolidate a subsidiary include:

1. Sale by the parent of all or a portion of its ownership interest in the subsidiary resulting in the parent no longer holding a controlling financial interest.
2. Expiration of a contract that granted control of the subsidiary to the parent.
3. Issuance by the subsidiary of shares that reduces the ownership interest of the parent to a level not representing a controlling financial interest.
4. Loss of control of the subsidiary by the parent because the subsidiary becomes subject to control by a governmental body, court, administrator or regulator.

Should the parent's loss of controlling financial interest occur through two or more transactions, management of the former parent is to consider whether the transactions should be accounted for as a single transaction. In evaluating whether to combine the transactions, management of the former parent is to consider all of the terms and conditions of the transactions as well as their economic impact. The presence of one or more of the following indicators may lead to management concluding that it should account for multiple transactions as a single transaction:



1. The transactions are entered into simultaneously or in contemplation of one another.
2. The transactions form a single transaction designed to achieve an overall commercial effect.
3. The occurrence of one transaction depends on the occurrence of at least one other transaction.
4. One transaction, when considered on its own merits, does not make economic sense, but when considered together with the other transaction or transactions would be considered economically justifiable.

Obviously, this determination requires the exercise of sound judgement and attention to economic substance over legal form.

When control of a subsidiary is lost and a non-controlling interest is retained, consistent with the approach applied in step acquisitions, the parent should measure that retained interest at fair value and recognize, in profit or loss, a gain or loss on disposal of the controlling interest. The gain or loss is measured as follows:

FVCR	=	Fair value of consideration received, if any
FVNIR	=	Fair value of any non-controlling investment retained by the former parent at the derecognition date (the date control is lost)
DISTRoS	=	Any distribution of shares of the subsidiary to owners
CVNI	=	Carrying value of the non-controlling interest in the former subsidiary on the derecognition date, including any accumulated other comprehensive income attributable to the non-controlling interest
CVAL	=	Carrying value of the former subsidiary's assets (including goodwill) and liabilities at the derecognition date
		$(FVCR + FVNIR + DISTRoS + CVNI) - CVAL = \text{Gain (Loss)}$

**Example of accounting for the parent's loss of control of a subsidiary**

Konin Corporation (KC) owns an 85% interest in Donna Corporation (DC). On January 1, 20XX, KC decided to sell a 50% interest in DC to a third party in exchange for cash of €600,000. At the disposal date the total fair value of DC amounts to €1,000,000. Furthermore in KC's consolidated financial statements the carrying value of DCs net assets is €1,000,000 and the carrying value of the non-controlling interest in DC (including the non-controlling interest's share of accumulated other comprehensive income) is €100,000. As a result of this transaction, KC loses control of DC but retains a 35% interest in the former subsidiary, valued at €350,000 on that date. The gain or loss on the disposal of 50% interest in DC is calculated as follows:

Cash received	€600,000
Fair value of retained non-controlling interest	350,000
Carrying value of DCs non-controlling interest	100,000
	1,050,000
Less: Carrying value of DCs net assets	1,000,000
Gain on disposal	€50,000

If a parent loses control of a subsidiary, it must recognize all amounts that were previously reported for the relevant subsidiary in other comprehensive income. Recognition takes place on the same basis as would have been prescribed by the parent company for a direct disposal of the corresponding assets or liabilities. Example: Subsidiary X is sold by parent company A. The previous consolidated balance sheet contained reserves available-for-sale pursuant to IAS 39/IFRS 9 and actuarial losses pursuant to IAS 19 resulting from

subsidiary X. At the time of the loss of control of X, A must reclassify the reserve available-for-sale to profit or loss, and leave the remeasurements of the net defined benefit liability (asset) recognized in other comprehensive income under IAS 19 in the consolidated equity of A. This is because, under IAS 19.122, remeasurements shall not be reclassified to profit or loss in a subsequent period, and under IAS 39.55(b) the reserve available-for-sale must be reclassified on the sale of the securities.

### **Investment Entities**

*Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), issued in October 2012, introduced an exception to the principle that required all subsidiaries to be consolidated. The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 (or IAS 39) instead of consolidating those subsidiaries in its consolidated and separate financial statements. These amendments come into effect for reporting periods beginning after January 1, 2014, a full year after the effective date of the original versions of the standards. Early application of the amendments is permitted, provided that entities disclose the early adoption and apply all aspects of the amendments simultaneously.

A parent of an investment entity has to consolidate all entities that it controls. Even those subsidiaries who are controlled by an investment entity, unless the parent itself is an investment entity (IFRS 10.33).

Example: Vehicle manufacturer X is the parent company of investment entity B. B has holdings in various companies that are not active in the automotive sector. Whereas X is not an investment entity pursuant to IFRS 10, B is classed as an investment entity pursuant to IFRS 10. For the purposes of this example it should be assumed that both X and B must prepare consolidated financial statements. Solution: Since B is an investment entity, it must report companies in which it holds a controlling interest at fair value through profit or loss. X, conversely, must fully consolidate all its subsidiaries, including B.

### **Definition**

IFRS 10 requires a parent to determine whether it is an investment entity. An investment entity is defined an entity that:

- a) Obtains funds from one or more investors for the purpose of providing those investors with investment management services;
- b) Commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and
- c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

The standard explains that an investment entity will usually display the following typical characteristics, which entities should consider in determining whether the definition is met:

- a) It will have more than one investment;
- b) It will have more than one investor;
- c) It will have investors that are not related parties of the entity; and
- d) It will have ownership interests in the form of equity or similar interests.

Although these typical characteristics are not essential factors in determining whether an entity qualifies to be classified as an investment entity, the standard does require an

investment entity that does not have all of these typical characteristics to provide additional disclosure regarding the judgement made in arriving at the conclusion that it is in fact an investment entity.

### ***Investment management services***

From the point of view of the IASB one of the essential activities of an investment entity is that it obtains funds from investors in order to provide those investors with investment management services. Even though detailed guidance is not given about the first criteria of the definition, the IASB notes that this provision differentiates investment entities from other entities.

### ***Business purpose***

The purpose of an investment entity should be to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both. This would typically be evident in documents such as the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents. Further evidence may include the manner in which the entity presents itself to other parties (such as potential investors or potential investees).

#### **Example of business purpose**

Investo's offering memorandum describes its business purpose to be ". . . the undertaking of investment activities for the purpose of earning investment income and capital appreciation." However, its practice thus far has been to jointly develop, produce or market products with its investees. Notwithstanding its stated business purpose, Investo's actual business purpose is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments.

An investment entity may provide investment-related services (for example, investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as to its investors, even if those activities are substantial to the entity. However, such services should not be offered to investees, unless if they are undertaken to maximize the entity's investment return. In addition, if these services to investees represent a separate substantial business activity or a separate substantial source of income to the entity, it would not be able to classify itself as an investment entity in the context of IFRS 10.

### ***Exit strategies***

A common characteristic of investment entities is that they would not plan to hold investments indefinitely. The standard requires an investment entity to have an exit strategy documenting how the entity plans to realize capital appreciation from substantially all of its equity investments and non-financial asset investments. An investment entity would also be required to have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. Although it is not necessary to document specific exit strategies for each individual investment, an investment entity should at least be able to identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments. For the purposes

of this assessment, it would not be sufficient to consider exit mechanisms that are only put in place for default events, such as breach of contract or non-performance.

Examples of exit strategies for private equity securities could include:

- An initial public offering;
- A private placement;
- A trade sale of a business;
- Distributions (to investors) of ownership interests in investees; and
- Sales of assets (including the sale of an investee's assets followed by a liquidation of the investee).

Examples of exit strategies for publicly trade equity securities could include:

- Selling the investment in a private placement or in a public market.

Examples of exit strategies for real estate investments include:

- Sale of the real estate through specialized property dealers or the open market.

### ***Earnings from investments***

An entity would not be investing solely for capital appreciation, investment income, or both, if the entity or another member of the group to which the entity belongs obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee.

Examples of benefits which would usually result in disqualification from investment entity status include:

- a) The acquisition, use, exchange or exploitation of the processes, assets or technology of an investee;
- b) Joint arrangements or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;
- c) Financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member;
- d) An option held by a related party of the entity to purchase, from that entity or another group member, an ownership interest in an investee of the entity;
- e) Transactions between the entity or another group member and an investee that:
  - i. Are on terms that are unavailable to entities that are not related parties of either the entity, another group member or the investee;
  - ii. Are not at fair value; or
  - iii. Represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities.

#### **Example Biotechnology Fund (based on IFRS 10 para IE 7, example 2):**

Select Biotechnology Fund was formed by Pharma Ltd. to invest in pharmaceuticals start-up companies for capital appreciation. Pharma Ltd holds an 80% interest in Select Biotechnology Fund and controls Select Biotechnology Fund; the other 20% ownership interest in Select Biotechnology Fund is owned by 10 unrelated investors. Pharma Ltd. holds options to acquire investments held by Select Biotechnology Fund, at fair value, which would be exercised if the certain medical trials of pharmaceuticals products developed by investees would benefit

the operations of Pharma Ltd. No plans for exiting the investments have been identified by Select Biotechnology Fund. Select Biotechnology Fund is managed by an investment adviser that acts as agent for the investors in Select Biotechnology Fund.

Can Select Biotechnology Fund be considered as an investment company? Although Select Biotechnology Fund has the business purpose to invest for capital appreciation and it provides investment management services to its investor, Select Biotechnology Fund is not an investment entity for two reasons: (1) Pharma Ltd., the parent of Select Biotechnology Fund, holds options to acquire investments in investees held by Select Biotechnology Fund if the assets developed by the investees would benefit the operations of Select Biotechnology Fund. This provides a benefit in addition to capital appreciation or investment income; and (2) the investment plans of Select Biotechnology Fund do not include exit strategies for its investments, which are equity investments. The options held by Pharma Ltd. are not controlled by Select Biotechnology Fund and do not constitute an exit strategy.

### ***Fair value measurement***

An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis. An investment entity would ordinarily be expected to provide investors with fair value information and measure substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with IFRS Standards. Investment entities would typically also report fair value information internally to the entity's key management personnel (as defined in IAS 24), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions. Areas where fair value would be expected to feature as the accounting policy of choice for accounting for investments include:

- Electing to account for any investment property using the fair value model in IAS 40 Investment Property;
- Electing the exemption from applying the equity method in IAS 28 for investments in associates and joint ventures; and
- Measuring financial assets at fair value using the requirements in IFRS 9 (or IAS 39).

These choices would be expected for all investment assets, but an investment entity would not be expected to measure any non-investment assets at fair value. Thus, there would be no requirement for non-investment assets (such as property, plant and equipment, or intangible assets) or liabilities to be measured at fair value.

In determining whether it meets the definition of an investment entity the following typical characteristics could be used. The absence of any of these characteristics may indicate that an entity does not meet the definition of an investment entity. If an entity does not meet one or more of the typical characteristics, additional judgement is necessary in determining whether an entity is an investment entity.

### ***More than one investment***

An investment entity typically holds several investments to diversify risk and maximize returns. An investment entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments. There may be times when the entity holds a single investment. However,

holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity. For example, an investment entity may hold only a single investment when the entity is in its start-up period, or has not yet made other investments to replace those it has disposed of. In some cases, an investment entity may be established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (for example, when the required minimum investment is too high for an individual investor). In such a situation, the entity with a single investment could still meet the definition of an investment entity, but these circumstances would have to be explained in the judgments applied by management.

#### ***More than one investor***

An investment entity would typically have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income. Alternatively, an investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund, government investment fund or family trust). The standard also explains that the entity's investors would typically be unrelated to one another, again making it less likely that there would be any other benefits to investors besides capital appreciation or investment income.

#### ***Unrelated investors***

An investment entity normally has various investors who are not related to the company or to other members of the company. The existence of unrelated parties is an indication that the companies or members of the company derive advantages from the investment other than increases in value or capital returns. Even if the investors are related to one another, however, the possibility of qualifying the company as an investment entity exists. An investment entity may, for example, set up a separate parallel fund for a group of its employees in order to reward them.

#### ***Change in status***

Since the determination of investment entity status is dependent on an assessment of the relevant facts and circumstances at a point in time, an entity's status may change over time. If facts and circumstances indicate there changes to one or more of the three elements that qualify an entity to be an investment entity, a parent need to reassess whether it is an investment entity (IFRS 10.29). If an entity's status changes due to a change in circumstances, the effects of the change are accounted for prospectively. When an entity that was previously classified as an investment entity ceases to be an investment entity, it applies IFRS 3, *Business Combinations*, to any subsidiary that was previously measured at fair value through profit or loss. The date of the change of status is the deemed acquisition date for the purposes of applying the acquisition method, and the fair value of the subsidiary at the deemed acquisition date represents the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. The entity consolidates its subsidiaries with effect from the deemed acquisition date until control is lost.

If an entity becomes an investment entity, it deconsolidates its subsidiaries at the date of the change in status. The deconsolidation of subsidiaries is accounted for as though the investment entity has lost control of those subsidiaries at that date, and any difference between the fair value of the retained investment and the net asset value of the former subsidiary is recognized in profit or loss.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

### Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX

#### 19. Investment in subsidiaries

##### Composition of the Group

Name	Country of incorporation	Proportion of ownership interest		Proportion owned by subsidiary companies		Principal Activities	Wholly or non-wholly owned subsidiary	IFRS12 p10 p4, B4, B5, B6
		20XX	20XX-1	20XX	20XX-1			
Subsidiary A	UK	48%	48%	–	–	Distribution of widgets	Non-wholly	
Subsidiary B	UK	90%	100%			Manufacturing of widgets	Non-wholly	
Subsidiary C	France	–	–	90%	90%	Retail of widgets	Non-wholly	
Company A	UK	100%	100%	–	–	Manufacturing of widgets	Wholly	
Company B	France	100%	100%	–	–	Distribution of widgets	Wholly	

##### Details of non-wholly owned subsidiaries that have material non-controlling interests

Name of subsidiary	Proportion of ownership interest held by non-controlling interest		Profit or loss allocated to non-controlling interest		Accumulated non-controlling interests		IFRS12 p10 p12 B11
	20XX	20XX-1	20XX	20XX-1	20XX	20XX-1	
Subsidiary A (a)	52%	52%	X	X	X	X	
Subsidiary B	10%	0%	X	–	X	–	
Subsidiary C	10%	10%	X	X	X	X	
Total					<u>X</u>	<u>X</u>	

- (a) The group owns 48% equity shares of Subsidiary A. The remaining 52% is widely held by thousands of unrelated shareholders. An assessment of control was performed by the group based on whether the group has the practical ability to direct the relevant activities unilaterally and it was concluded that the group had a dominant voting interest to direct the relevant activities of Subsidiary A and it would take a number of vote holders to outvote the group, therefore the group has control over Subsidiary A and Subsidiary A is consolidated in these financial statements.

IFRS 12 p9

**Summarized financial information**

Summarized financial information in respect of each of the Group's subsidiaries that has material non-controlling interests is set out below. The summarized financial information below represents amounts before intragroup eliminations.

IFRS12  
p12  
B10, B11

	Subsidiary A		Subsidiary B		Subsidiary C	
	20XX	20XX-1	20XX	20XX-1	20XX	20XX-1
Current assets	X	X	X	-	X	X
Non-current assets	X	X	X	-	X	X
Current liabilities	(X)	(X)	(X)	-	(X)	(X)
Non-current liabilities	(X)	(X)	(X)	-	(X)	(X)
Equity attributable to owners of the company	X	X	X	-	X	X
Non-controlling interests	X	X	X	-	X	X
Revenue	X	X	X	-	X	X
Expenses	(X)	(X)	(X)	-	(X)	(X)
<b>Profit or loss for the year</b>	X	X	X	-	X	X
Profit or loss attributable to owners of the company	X	X	X	-	X	X
Profit or loss attributable to the non-controlling interests	X	X	X	-	X	X
<b>Profit or loss for the year</b>	X	X	X	-	X	X
Other comprehensive income attributable to owners of the company	X	X	X	-	X	X
Other comprehensive income to the non-controlling interests	X	X	X	-	X	X
<b>Other comprehensive income for the year</b>	X	X	X	-	X	X



**19. Investment in subsidiaries** *(continued)*

Total comprehensive income attributable to owners of the company	X	X	X	-	X	X
Total comprehensive income to the non-controlling interests	X	X	X	-	X	X
<b>Total comprehensive income for the year</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>-</b>	<b>X</b>	<b>X</b>
<b>Dividends paid to non-controlling interests</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Net cash in/(out) flow from operating activities	X	X	X	-	X	X
Net cash in/(out) flow from investing activities	(X)	X	X	-	(X)	X
Net cash in/(out) flow from financing activities	(X)	X	(X)	-	(X)	(X)
<b>Net cash in/(out) flow</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>-</b>	<b>X</b>	<b>X</b>

**Change in the groups ownership interest in a subsidiary**

IFRS12 p18

10% of the group's interest in Subsidiary was disposed of during the year, reducing its continuing interest to 90%. The difference between the consideration received of X and the increase in the non-controlling interest of X has been credited to retained earnings.

**Significant restrictions**

IFRS12 p13

There are no significant restrictions on the company's or subsidiary's ability to access or use the assets and settle the liabilities of the group.

**Financial support**

IFRS12 p14

The group has not given any financial support to a consolidated structured entity. p15, p16, p17

**JOINT ARRANGEMENTS****Scope**

IFRS 11, *Joint Arrangements*, deals with financial reporting by parties to a joint arrangement. IFRS 11 did replace IAS 31, *Interest in Joint Ventures*, and SIC 13, *Jointly Controlled Entities—Non-monetary Contributions by Venturers*, and sets principles for the accounting for all joint arrangements. Joint arrangements are classified in two types: joint operations and joint ventures. The party to a joint arrangement must determine the type of joint arrangement it is involved in by assessing its rights and obligations created by the arrangement.

## Joint Arrangements

A joint arrangement is defined as an arrangement of which two or more parties have joint control and has two characteristics: (1) the parties must be bound by contractual arrangement, and (2) the contractual arrangement must give two or more of the parties joint control over the arrangement. Therefore not all parties need to have joint control. IFRS 11 distinguishes between parties that have joint control and parties that participate in the joint arrangement but do not have joint control. Judgement is applied to assess whether parties have joint control by considering all the facts and circumstances. If the facts and circumstances change, joint control must be reassessed.

Enforceable contractual arrangements are normally created through a written contract or other documented discussions between the parties. However, statutory mechanisms (articles of associated, charters, bylaws and similar mechanisms) can also create enforceable arrangements on their own or in conjunction with the written documentation. The contractual arrangement normally deals with activities such as:

- The purpose, activity or duration of the arrangement;
- How members of the board of directors or other governing body are appointed;
- The decision-making process;
- The capital or other contributions required;
- How parties share assets, liabilities, revenue, expenditure or the profit or loss.

Joint control is defined as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. The parties must assess whether the contractual arrangement gives them control collectively. Parties control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement (the relevant activities). The collective control could be created by all the parties or a group of parties.

Even if collective control is established, joint control exists only when decisions about the relevant activities require the unanimous consent of all the parties that control the arrangement collectively. This can either be explicitly agreed or implicit in the arrangement. For instance, two parties may each hold 50% of the voting rights, but the arrangement states that more than 50% of the voting rights are needed to make decisions about the relevant activities. Because the parties must agree in order to make decisions, joint control is implied.

When a minimum required proportion of rights required are needed to make decisions can be achieved by different combinations of parties agreeing, joint control is normally not established.

The requirement of unanimous consent means that any party with joint control can prevent any of the other parties from making unilateral decisions about the relevant activities. However, clauses on the resolving of disputes, such as arbitration, do not prevent the arrangement from being a joint arrangement.

Identifying a joint arrangement is based on answering the following two questions positively:

1. Does the arrangement give all the parties, or a group of parties, control of the arrangement collectively?
2. Do decisions about the relevant activities require the unanimous consent of all the parties, or of a group of parties, that collectively control the arrangement?

## Types of Joint Arrangements

Joint arrangements are classified as either joint operations or joint ventures. A joint operation is defined as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. A joint venture is defined as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. The classification is thus dependent on the rights and obligations of the parties to the arrangements:

<i>Type</i>	<i>Rights and Obligations</i>
Joint operation	Rights to the assets, and obligations for the liabilities, relating to the arrangement.
Joint venture	Rights to the net assets of the arrangement

A joint operator has rights and obligations directly in the assets and liabilities, while a joint venturer has rights in the net assets.

Judgement is applied in assessing whether a joint arrangement is a joint operation or a joint venture. Rights and obligations are assessed by considering the structure and legal form, the terms agreed by the parties and other facts and circumstances. The joint arrangement could be structured through a separate vehicle. IFRS 11 specifically states that a joint arrangement that is not structured through a separate vehicle is a joint operation. This is because no rights and obligations in the net assets are created.

If a joint arrangement is structured through a separate vehicle, an assessment must be made to establish whether it is a joint operation or a joint venture, based on the rights and obligations created. A separate vehicle does not automatically indicate a right in the net assets. Specifically, in the case of a separate vehicle, the assessment is based on the legal form, the terms of the contractual arrangement, and other relevant facts and circumstances.

The legal form could create a separate vehicle that is considered in its own right. The separate vehicle holds the assets and liabilities and not the parties to the arrangement. By implication the parties have only indirect rights in the net assets, which indicates a joint venture. In contrast, the legal form will create a joint operation, when the legal form does not create a separation between the parties and the separate vehicle.

However, when a separation is created between the parties and the separate vehicle, a joint venture is not automatically assumed. The terms of the contractual arrangement and, if relevant, other factors and circumstances can override the assessment of the rights and obligations conferred upon the parties by the legal form. The contractual arrangement could be used to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle. When the contractual arrangement specifies that the parties have rights to the assets and obligations for the liabilities, the arrangement is a joint operation and other facts and circumstances do not need to be considered. IFRS 11 includes the examples set out in the table below to identify when the contractual arrangements created a joint operation or joint venture.

### Examples of classification based on the contractual agreement

#### **Joint operation**

The parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specific proportion.

The parties are liable for claims raised by third parties.

The allocation of the revenue and expenses is based on the relative performance of each party. In this case, the allocations of revenue and expenses differ from the interest in the net assets, if any.

**Joint venture**

The joint arrangement is liable for the debts and obligations of the arrangement.

The parties to the joint arrangement are liable to the arrangement only to the extent of their respective investments in the arrangement.

The parties to the joint arrangement are liable to the arrangement only to their respective obligation to contribute any unpaid or any additional capital to the arrangement.

Creditors of the joint arrangement do not have rights or recourse against any party with respect to debts or obligations of the arrangement.

Each party's shares in the profit and loss relating to the activities of the arrangement is established.

Other facts and circumstances are assessed to classify the joint arrangement when the terms of the arrangement are not conclusive. IFRS 11 provides one situation when other facts and circumstances override the legal form and contractual arrangement. When the activities of the arrangement are designed to provide output mainly to the joint parties and the arrangement is limited in its ability to sell to third parties, it is an indication that the joint parties have rights to substantially all the economic benefits of the arrangement. The effect of such an arrangement is that the liabilities incurred by the arrangement are, in substance, settled by the cash flows received from the joint parties for their share of the output. Since the joint parties are substantially the only contributor to the cash of the joint arrangement, they indirectly assume responsibility for the liabilities.

A joint arrangement through a separate vehicle is not automatically a joint venture. Only if the answers to all three of the questions identified in the table below are negative would the separate vehicle be classified as a joint venture:

**Assessment Questions**

1. Does the legal form of the separate vehicle give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement?
2. Do the terms of the contractual arrangement specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement?
3. Have the parties designed the arrangement so that:
  - Its activities primarily aim to provide the parties with an output (i.e., the parties have rights to substantially all the economic benefits of the assets held in the separate vehicle); and
  - It depends on the parties on a continuous basis for settling the liabilities relating to the activity conducted through the arrangement?

**Accounting for Joint Operations**

*Basic principles*

The principle established in IFRS 11 is that joint operations should be accounted for by following the contractual arrangement established between the parties to the joint arrangement. In its own financial statements, a joint operator will account in accordance with IFRS 11.20 for the following:

- Its assets, including its share of any assets held jointly;

- Its liabilities, including its share of any liabilities incurred jointly;
- Its revenue from the sale of its share of the output arising from the joint operation;
- Its share of the revenue from the sale of the output by the joint operation; and
- Its expenses, including its share of any expense incurred jointly.

It is clear that in a joint operation, a joint operator could either have an interest in the assets or incur the liabilities or expenses, directly as its own assets, liabilities and expenses, or the joint operator could have a shared interest. If a shared interest exists, the terms of the contractual arrangement will determine each operator's share. Once a joint operator's direct or shared interest in the assets, liabilities, income and expenses is determined, the joint operator accounts for them by following the IFRS applicable in each instance.

Special guidelines are also provided for transactions, such as the sale, contribution or purchase of assets between the entity of the joint operator and the joint operations. The joint operator only recognizes gains and losses resulting from sales and contributions to the joint operation to the extent of other parties' interest in the joint operations. Therefore, if a joint operator has a 40% interest in the joint operation it will only recognize 60% of the profit or losses on the transactions attributable to the other joint operators. The logic is that a portion of the profit has in fact been realized. As a further example, if venturers A, B and C jointly control joint operation D (each having a 1/3 interest), and A sells equipment having a book value of €40,000 to the operation for €100,000, only 2/3 of the apparent gain of €60,000 or €40,000 may be realized. However, if the transaction provides evidence of an impairment or reduction in the net realizable value of the assets sold or contributed, the joint operator must recognize the loss fully.

Similarly, if joint operators purchase assets from the joint operation, it may not recognize its share of gains and losses until the assets are resold to other parties. Again, if such transaction provides evidence of an impairment or reduction in the net realizable value of the assets purchased, the joint operator must recognize its full share of the losses.

A party to an arrangement that is a joint operation that does not have joint control, but has rights to the assets and obligations for the liabilities of the joint operation, accounts for its interest by following the principle established in IFRS 11. However, if the participating party does not have rights to the assets and obligations for the liabilities, it accounts for its interest in the joint operation by applying the applicable IFRS.

#### ***Accounting for acquisitions of interests in joint operations in which the activity constitutes a business***

In May 2014 the IASB issued the amendments to IFRS 11 "Accounting for Acquisitions of Interests in Joint Operations" ruling the accounting for acquisitions of interests in joint operations in which the activity constitutes a business. Those amendments, which are explained below, shall be applied prospectively in annual periods beginning on or after January 1, 2016. Earlier application is permitted. If an entity applies those amendments in an earlier period it shall disclose that fact. This Amendment had not yet been endorsed for IFRS users in the EU at the time of going to press. The reason why the IASB decided on this Amendment is that it was unclear how acquisitions of interests in joint operations in which the activity constitutes a business are to be reported. Now it has been clarified, that when an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business, as defined in IFRS 3 it shall apply, to the extent of its share in the assets, liabilities in a joint operation (see IFRS 11.20), all of the principles on business combinations accounting in IFRS 3, and other IFRSs, that do not conflict with the guidance

in IFRS 11 and disclose the information that is required in those IFRSs in relation to business combinations. This applies to the acquisition of both the initial interest and additional interests in a joint operation in which the activity of the joint operation constitutes a business. According to IFRS 11, these principles on business combinations accounting that do not conflict with the guidance in IFRS 11 include but are not limited to:

- Measuring identifiable assets and liabilities at fair value, other than items for which exceptions are given in IFRS 3 and other IFRSs;
- Recognizing acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognized in accordance with IAS 32 and IFRS 9 (or IAS 39);
- Recognizing deferred tax assets and deferred tax liabilities that arise from the initial recognition of assets or liabilities, except for deferred tax liabilities that arise from the initial recognition of goodwill, as required by IFRS 3 and IAS 12 for business combinations;
- Recognizing the excess of the consideration transferred over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, if any, as goodwill; and
- Testing for impairment a cash-generating unit to which goodwill has been allocated at least annually, and whenever there is an indication that the unit may be impaired, as required by IAS 36 for goodwill acquired in a business combination.

These principles also apply to the formation of a joint operation if, and only if, an existing business, as defined in IFRS 3, is contributed to the joint operation on its formation by one of the parties that participate in the joint operation. However, these principles do not apply to the formation of a joint operation if all of the parties that participate in the joint operation only contribute assets or groups of assets that do not constitute businesses to the joint operation on its formation. These principles do also not apply on the acquisition of an interest in a joint operation when the parties sharing joint control, including the entity acquiring the interest in the joint operation, are under the common control of the same ultimate. A joint operator might increase its interest in a joint operation in which the activity of the joint operation constitutes a business, as defined in IFRS 3, by acquiring an additional interest in the joint operation. In such cases, previously held interests in the joint operation are not remeasured if the joint operator retains joint control.

**Example (based on IFRS 10 para 11 IE 53; example 7):**

Entities A, B and C have joint control of joint operation X whose activity constitutes a business, as defined in IFRS 3. Entity D acquires company A's 40 per cent ownership interest in Joint Operation X at a cost of €500,000 and incurs acquisition-related costs of €70,000.

The contractual arrangement between the counterparts that entity D joined as part of the acquisition institutes that entity D's shares in several assets and liabilities vary from its ownership interest in joint operation X. The following table sets out entity D's share in the assets and liabilities related to joint operation X as established in the contractual arrangement between the counterparts:

Entity D's share in the assets and liabilities related to joint operation X	
Property, plant and equipment	52%
Intangible assets (excluding goodwill)	89%

Accounts receivable	38%
Inventory	42%
Retirement benefit obligations	17%
Accounts payable	45%
Contingent liabilities	49%

### Conclusion

Entity D recognizes in its financial statements its share of the assets and liabilities resulting from the contractual arrangement (see IFRS 11.20). It applies the principles on business combinations accounting in IFRS 3 and other IFRSs for identifying, recognizing, measuring and classifying the assets acquired, and the liabilities assumed, on the acquisition of the interest in joint operation X. This is because entity D acquired an interest in a joint operation in which the activity constitutes a business. However, entity D does not apply the principles on business combinations accounting in IFRS 3 and other IFRSs that conflict with the guidance in IFRS 11. Consequently, in accordance with IFRS 11.20, entity D recognizes, and therefore measures, in relation to its interest in joint operation X, only its share in each of the assets that are jointly held and in each of the liabilities that are incurred jointly, as stated in the contractual arrangement. Entity D does not include in its assets and liabilities the shares of the other parties in joint operation X. Due to IFRS 3 the D has to measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values with limited exceptions; for example, deferred tax assets and deferred tax liabilities are not measured at fair value but are measured in accordance with IAS 12. Such measurement does not conflict with this IFRS and thus those requirements apply.

Consequently, entity D determines the fair value, or other measure specified in IFRS 3, of its share in the identifiable assets and liabilities related to joint operation X. The following table sets out the fair value or other measure specified by IFRS 3 of entity D's shares in the identifiable assets and liabilities related to joint operation X:

Fair value or other measure specified by IFRS 3 for Company X's shares in the identifiable assets and liabilities of joint operation	€
Property, plant and equipment	145,000
Intangible assets (excluding goodwill)	83,000
Accounts receivable	78,000
Inventory	60,000
Retirement benefit obligations	(18,000)
Accounts payable	(55,000)
Contingent liabilities	(60,000)
Deferred tax liability	(45,000)
Net assets	188,000

In accordance with IFRS 3, the excess of the consideration transferred over the amount allocated to entity D's shares in the net identifiable assets is recognized as goodwill:

Consideration transferred	€500,000
Company E's shares in the identifiable assets and liabilities relating to its interest in the joint operation	€188,000
Goodwill	€312,000

Acquisition-related costs of €70,000 are not considered to be part of the consideration transferred for the interest in the joint operation. In accordance with IFRS 3.53 they are

recognized as expenses in profit or loss in the period that the costs are incurred and the services are received.

### **Accounting for Joint Ventures**

A joint venturer recognizes its interest in a joint venture as an investment by applying the equity method of accounting as described in IAS 28, *Investment in Associates and Joint Ventures*. The proportionate consolidation method of accounting that was previously permitted for jointly controlled entities under IAS 31 is no longer available to joint ventures. Any participating party in the joint venture that does not have joint control accounts for its interest by applying IFRS 9 (or IAS 39), unless it has significant influence over the joint venture. If the participating party has significant influence, it too will apply equity accounting in accordance with IAS 28.

### **Separate Financial Statements**

The accounting for a joint operation in the consolidated and separate financial statements is the same. A party that participates in a joint operation that does not have joint control must also apply the same principles as discussed above to account for its interest.

Equity accounting is not only applied in the consolidated financial statements of the joint venture. In the separate financial statements IAS 27, *Separate Financial Statements*, does also allow the application of equity accounting. For further details please see below.

## **ASSOCIATES**

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### **Identification of an Associate**

An associate is an entity over which an investor has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not in control or joint control of those policies.

In defining the concept of significant influence, there was recognition that the actual determination of the existence of significant influence could be difficult and that, to facilitate such recognition, there might be a need to set out a bright line against which significant influence would be measured. To this end, a somewhat arbitrary, refutable presumption of such influence was set at a 20% (direct or indirect) voting power in the investee. This has been held out as the de facto standard on assessing significant influence, and thus an investor accounts for such an investment as an associate unless it can prove otherwise. If the investor holds less than 20% voting power, it is presumed that significant influence is not applicable, unless such influence can be clearly demonstrated. Specifically, a substantial or majority ownership from another party does not preclude significant influence.

No top bright line (such as 50%) is set to identify significant influence. In difficult situations control must first be considered. The reason is that control could be achieved with a voting power of less than 50%. If control is not applicable and the voting power is above 20%, significant influence is assumed, unless it can be demonstrated otherwise.

In assessing significant influence, all facts and circumstances are assessed, including the term of exercise of potential voting rights and any other contractual arrangements. The following factors are indicators of significant influence:

- Representation on the board of directors or equivalent governing body;
- Participation in policy-making process, including decisions about dividends and other distributions;



- Material transactions between parties;
- Interchange of managerial personnel;
- Provision of essential technical information.

Only the existence and effect of potential voting rights that are currently exercisable or convertible is considered in the assessment. Potential voting rights exist in the form of options, warrants, convertible shares, or a contractual arrangement to acquire additional shares. In making the assessment, all facts and circumstances, such as the terms of exercise and other contractual arrangements that affect potential rights must be considered. Potential voting rights held by others must also be considered. Intentions of management and the financial ability to exercise or convert are, however, not considered.

### **Accounting for an Associate**

An entity recognizes its interest in an associate by applying the equity method of IAS 28, *Investment in Associates and Joint Ventures*, except if an exception is applicable.

## **EQUITY METHOD OF ACCOUNTING**

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### **Scope and Application**

The equity method of accounting is applied to investments in associates and joint ventures.

The cost method for accounting for associates would simply not reflect the economic reality of the investor's interest in an entity whose operations were indicative, in part at least, of the reporting entity's (i.e., the investor's) management decisions and operational skills. Thus, the clearly demonstrable need to reflect substance, rather than mere form, made the development of the equity method highly desirable. This is in keeping with the thinking that is currently driving IFRS that all activities that have a potential impact on the financial position and performance of an entity must be reported, including those that are deemed to be off-balance-sheet-type transactions.

The equity method is applied to an investment in a joint venture since the investor has an interest in the net assets of the joint venture. The investor has no direct interest in the underlying assets or liabilities of the venture and can therefore not recognize such assets or liabilities.

An exception is applicable to investments in associates or joint ventures held (directly or indirectly) by a venture capital organization or a mutual fund, unit trust or similar entity, including unit-link insurance funds. Such entities may elect to measure the investment at fair value through profit and loss in accordance with IFRS 9. When those investments are measured at fair value, changes in fair value are included in profit or loss in the period of the change. This election may also be applied to a portion of investment in associates or joint ventures held indirectly through such exempted entities. The other portion of the investment in the associate or joint venture should still be equity accounted.

IFRS 5 is applied to an investment (or a portion) in an associate or joint venture that meets the requirements to be classified as held-for-sale (see Chapter 13). The portion of the investment that is not classified as held-for-sale must still be equity accounted until disposal of the held-for-sale portion takes place. After the disposal, the remaining portion must be reassessed to determine whether it is still an investment in associate or joint venture, and if not, recorded in terms of IFRS 9.

Specifically an entity that has control over a subsidiary and is exempt from consolidating the subsidiary because its ultimate or intermediate parent does prepare financial statements, is not required to apply the equity method.

## The Equity Method

### *Basic principles*

The equity method permits an entity (the investor) controlling a certain share of the voting interest in another entity (the investee) to incorporate its pro rata share of the investee's operating results into its profit or loss. However, rather than include its share of each component of the investee's revenues, expenses, assets and liabilities into its financial statements, the investor will only include its share of the investee's profit or loss as a separate line item in its statement of profit or loss and comprehensive income. Similarly, only a single line in the investor's statement of financial position is presented, but this reflects, to a degree, the investor's share in each of the investee's assets and liabilities.

Initially under the equity method the investment in the associate or joint venture is recognized at cost, and the carrying amount is increased or decreased to include the investor's share of the profit or loss of the investee after the acquisition date. The investor's share of the profit or loss is recognized in the investor's profit and loss. The carrying amount is also adjusted for the investor's share of other comprehensive income, and the contra entry is recognized in other comprehensive income. Distributions received from the investee reduce the carrying amount of the investment.

When determining the entity's share in the associate or joint venture, potential voting rights or other derivatives containing potential voting rights are ignored. The entity's share is solely based on the existing ownership interest. However, if an entity has, in substance, existing ownership because a transaction currently gives it access to the returns associated with an ownership interest, this right to returns is taken into account to determine the entity's share in profits. Such instruments that are included in the determination of the entity's share in the associate or joint venture are specifically excluded from IFRS 9, even if they meet the definition of a derivative.

Many of the procedures applicable to equity accounting are similar to the consolidation procedures discussed above.

#### **Example of a simple case ignoring deferred taxes**

Assume the following information:

On January 2, 20XX, Regency Corporation (the investor) acquired 40% of Elixir Company's (the investee) voting shares on the open market for €100,000. Unless demonstrated otherwise, it is assumed that Regency Corporation can exercise significant influence over Elixir Company's operating and financing policies. On January 2, Elixir's shareholders' equity is comprised of the following accounts:

Shares, par €1,100,000 shares authorized, 50,000 shares issued and outstanding	€ 50,000
Additional paid-capital/Share premium	150,000
Retained earnings	50,000
Total shareholders' equity	€250,000

Note that the cost of Elixir Company common shares was equal to 40% of the book value of Elixir's net assets. Assume also that there is no difference between the book value and the fair value of Elixir Company's assets and liabilities. Accordingly, the balance in the investment account in Regency's records represents exactly 40% of Elixir's shareholders' equity (net assets). Assume further that Elixir Company reported a 20XX net profit of €30,000 and paid cash dividends of €10,000. Its shareholders' equity at year-end would be as follows:

Shares, par €1,100,000 shares authorized, 50,000 shares issued and outstanding	€ 50,000
Additional paid-in capital/Share premium	150,000
Retained earnings	70,000
Total shareholders' equity	€270,000

Regency Corporation would record its share of the increase in Elixir Company's net assets during 20XX as follows:

Investment in Elixir Company	12,000	
Equity in Elixir profit or loss (€30,000 × 40%)		12,000

*Recognize the investment*

Cash	4,000	
Investment in Elixir Company (€10,000 × 40%)		4,000

*Recognize the dividend*

When Regency's statement of financial position is prepared at December 31, 20XX, the balance reported in the investment account would be €108,000 (= €100,000 + €12,000 – €4,000). This amount represents 40% of the book value of Elixir's net assets at the end of the year (40% × €270,000). Note also that, according to IAS 1.82 and IFRS 12.B16, the equity in Elixir's profit or loss is reported as one amount in Regency's profit or loss separately (e.g., Net income from associates).

### **Accounting at acquisition**

The principles regarding the acquisition of business combinations (Chapter 15) are also adopted in the acquisition of associates and joint ventures.

The equity method starts from the date an associate or joint venture is acquired. On the acquisition date, any positive difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is identified as goodwill and included in the carrying amount of the investment. Amortization of the goodwill is not allowed. Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is recognized as income and included in the entity's share of the associate's or joint venture's profit or loss for the year.

Adjustments are made to the entity's share of profit and losses of the associate or joint venture after acquisition to account for the effect of the fair value on acquisition, such as adjusted depreciation.

#### **Example of a complex case ignoring deferred taxes**

Assume again that Regency Corporation acquired 40% of Elixir Company's shares on January 2, 20XX, but that the price paid was €140,000. Elixir Company's assets and liabilities at that date had the following book and fair values:

	<u>Book value</u>	<u>Fair value</u>
Cash	€ 10,000	€ 10,000
Accounts receivable (net)	40,000	40,000
Inventories (FIFO cost)	80,000	90,000
Land	50,000	40,000
Plant and equipment (net of accumulated depreciation)	<u>140,000</u>	<u>220,000</u>
Total assets	<u>€320,000</u>	<u>€400,000</u>
Liabilities	<u>(70,000)</u>	<u>(70,000)</u>
Net assets (shareholders' equity)	<u>€250,000</u>	<u>€330,000</u>

The first order of business is the calculation of the differential, as follows:

Regency's cost for 40% of Elixir's ordinary share	€140,000
Book value of 40% of Elixir's net assets (€250,000 × 40%)	<u>(100,000)</u>
Total differential	<u>€ 40,000</u>

Next, the €40,000 is allocated to those individual assets and liabilities for which fair value differs from book value. In the example, the differential is allocated to inventories, land, and plant and equipment, as follows:

<i>Item</i>	<i>Book value</i>	<i>Fair value</i>	<i>Difference debit (credit)</i>	<i>40% of difference debit (credit)</i>
Inventories	€80,000	€90,000	€10,000	€4,000
Land	50,000	40,000	(10,000)	(4,000)
Plant and equipment	140,000	220,000	80,000	<u>32,000</u>
Differential allocated				<u>€32,000</u>

The difference between the allocated differential of €32,000 and the total differential of €40,000 is essentially identical to goodwill of €8,000. As shown by the following computation, goodwill represents the excess of the cost of the investment over the fair value of the net assets acquired.

Regency's cost for 40% of Elixir's ordinary share	€140,000
40% of Elixir's net assets (€330,000 × 40%)	<u>(132,000)</u>
Excess of cost over fair value (goodwill)	<u>€ 8,000</u>

At this point it is important to note that the allocation of the differential is not recorded formally by either Regency Corporation or Elixir Company. Furthermore, Regency does not remove the differential from the investment account and allocate it to the respective assets, since the use of the equity method does not involve the recording of individual assets and liabilities. Regency leaves the differential of €40,000 in the investment account, as part of the balance of €140,000 at January 2, 20XX. Accordingly, information pertaining to the allocation of the differential is maintained by the investor, but this information is outside the formal accounting system, which is comprised of journal entries and account balances.

After the differential has been allocated, the amortization pattern is developed. To develop the pattern in this example, assume that Elixir's plant and equipment have 10 years of useful life remaining and that Elixir depreciates its property, plant, and equipment on a straight-line basis. Under the provisions of IFRS 3, Regency may not amortize the unallocated differential, which is akin to goodwill, but must consider its possible impairment whenever IAS

39 indicates that the investment may be impaired. Regency would prepare the following amortization schedule:

<i>Item</i>	<i>Differential debit (credit)</i>	<i>Useful life</i>	<i>Amortization</i>		
			<i>20XX-1</i>	<i>20XX</i>	<i>20XX+1</i>
Inventories (FIFO)	€ 4,000	Sold in 20XX-1	€4,000	€ –	€ –
Land	(4,000)	Indefinite	–	–	–
Plant and equipment (net)	32,000	10 years	3,200	3,200	3,200
Goodwill	<u>8,000</u>	N/A	–	–	–
Totals	<u>€40,000</u>		<u>€7,200</u>	<u>€3,200</u>	<u>€3,200</u>

Note that the entire differential allocated to inventories is amortized in 20XX because the cost flow assumption used by Elixir is FIFO. If Elixir had been using weighted-average costing instead of FIFO, amortization might have been computed on a different basis. Note also that the differential allocated to Elixir's land is not amortized, because land is not a depreciable asset. Goodwill likewise is not subject to amortization.

The amortization of the differential, to the extent required under IFRS, is recorded formally in the accounting system of Regency Corporation. Recording the amortization adjusts the equity in Elixir's income that Regency recorded based on Elixir's statement of comprehensive income. Elixir's income must be adjusted because it is based on Elixir's book values, not on the cost that Regency incurred to acquire Elixir. Regency would make the following entries in 20XX, assuming that Elixir reported profit of €30,000 and paid cash dividends of €10,000:

1. Investment in Elixir	12,000	
Equity in Elixir income (€30,000 × 40%)		12,000
2. Equity in Elixir income (amortization of differential)	7,200	
Investment in Elixir		7,200
3. Cash	4,000	
Investment in Elixir (€10,000 × 40%)		4,000

The balance in the investment account on Regency's records at the end of 20XX is €140,800 [= €140,000 + €12,000 – (€7,200 + €4,000)], and Elixir's shareholders' equity, as shown previously, is €270,000. The investment account balance of €140,000 is not equal to 40% of €270,000. However, this difference can easily be explained, as follows:

Balance in investment account at December 31, 20XX	€140,800
40% of Elixir's net assets at December 31, 20XX	<u>108,000</u>
Difference at December 31, 20XX	<u>€ 32,800</u>
Differential at January 2, 20XX	€40,000
Differential amortized during 20XX	(7,200)
Unamortized differential at December 31, 20XX	<u>€ 32,800</u>

As the years go by, the balance in the investment account will come closer and closer to representing 40% of the book value of Elixir's net assets. After 20 years, the remaining difference between these two amounts would be attributed to the original differential allocated to land (a €4,000 credit) and the amount similar to goodwill (€8,000), unless written off due to impairment. This €4,000 difference on the land would remain until Elixir sold it.

To illustrate how the sale of land would affect equity method procedures, assume that Elixir sold the land in the year 2034 for €80,000. Since Elixir's cost for the land was €50,000, it would report a gain of €30,000, of which €12,000 (= €30,000 × 40%) would be recorded by Regency, when it records its 40% share of Elixir's reported profit, ignoring income taxes. However, from Regency's viewpoint, the gain on sale of land should have been €40,000 (€80,000 – €40,000)

because the cost of the land from Regency's perspective was €40,000 at January 2, 20XX. Therefore, besides the €12,000 share of the gain recorded above, Regency should record an additional €4,000 gain [(= €40,000 – €30,000) × 40%] by debiting the investment account and crediting the equity in Elixir income account. This €4,000 debit to the investment account will negate the €4,000 differential allocated to land on January 2, 20XX, since the original differential was a credit (the fair value of the land was €10,000 less than its book value).

### ***Intercompany transactions between investor and investee***

Transactions between the investor and the investee may require that the investor make certain adjustments when it records its share of the investee earnings. In terms of the concept that governs realization of transactions, profits can be recognized by an entity only when realized through a sale to outside (unrelated) parties in arm's-length transactions (sales and purchases) between the investor and investee. Similar problems can arise when sales of property, plant, and equipment between the parties occur. In all cases, there is no need for any adjustment when the transfers are made at carrying amounts (i.e., without either party recognizing a profit or loss in its separate accounting records).

In preparing consolidated financial statements, all intercompany (parent-subsidiary) transactions are eliminated. However, when the equity method is used to account for investments, only the profit component of intercompany (investor-investee) transactions is eliminated. This is because the equity method does not result in the combining of all statement of comprehensive income accounts (such as sales and cost of sales) and therefore will not cause the financial statements to contain redundancies. In contrast, consolidated statements would include redundancies if the gross amounts of all intercompany transactions were not eliminated.

Only the percentage held by the investor is eliminated and this also applies to unrealized profits and losses arising for both "upstream" and "downstream" transactions (i.e., sales from investee to investor, and from investor to investee) which should be eliminated to the extent of the investor's interest in the investee.

Elimination of the investor's interest in the investee, rather than the entire unrealized profit on the transaction, is based on the logic that in an investor-investee situation, the investor does not have control (as would be the case with a subsidiary), and thus the non-owned percentage of profit is effectively realized through an arm's length transaction. For purposes of determining the percentage interest in unrealized profit or loss to be eliminated, a group's interest in an associate is the aggregate of the holdings in that associate by the parent and its subsidiaries (excluding any interests held by non-controlling interests of subsidiaries). Any holdings of the group's other associates (i.e., equity method investees) or joint ventures are ignored for the purpose of applying the equity method. When an associate has subsidiaries, associates or joint ventures, the profits or losses and net assets taken into account in applying the equity method are those recognized in the associate's consolidated financial statements (including the associate's share of the profits or losses and net assets of its associates and joint ventures), after any adjustments necessary to give effect to the investor's accounting policies.

#### **Example of accounting for intercompany transactions**

Continue with the same information from the previous example and also assume that Elixir Company sold inventory to Regency Corporation in 20XX for €2,000 profit. Thirty percent of this inventory remains unsold by Regency at the end of 20XX-1. Elixir's net profit for 20XX, including

the gross profit on the inventory sold to Regency, is €20,000; Elixir's income tax rate is 34%. Regency should make the following journal entries for 20XX (ignoring deferred taxes):

1.	Investment in Elixir	8,000	
	Equity in Elixir income (€20,000 × 40%)		8,000
2.	Equity in Elixir income (amortization of differential)	3,600	
	Investment in Elixir		3,600
3.	Equity in Elixir income	158	
	Investment in Elixir (€2,000 × 30% × 66% × 40%)		158

The amount in the last entry needs further elaboration. Since 30% of the inventory remains unsold, only €600 of the intercompany profit is unrealized at year-end. This profit, net of income taxes, is €396. Regency's share of this profit (€158) is included in the first (€8,000) entry recorded. Accordingly, the third entry is needed to adjust or correct the equity in the reported net income of the investee.

Eliminating entries for intercompany profits in property, plant, and equipment are similar to those in the examples above. However, intercompany profit is realized only as the assets are depreciated by the purchasing entity. In other words, if an investor buys or sells property, plant and equipment from or to an investee at a price above book value, the gain would only be realized piecemeal over the asset's remaining depreciable life. Accordingly, in the year of sale the pro rata share (based on the investor's percentage ownership interest in the investee, regardless of whether the sale is upstream or downstream) of the unrealized portion of the intercompany profit would have to be eliminated. In each subsequent year during the asset's life, the pro rata share of the gain realized in the period would be added to income from the investee.

#### Example of eliminating intercompany profit on property, plant and equipment

Assume that Radnor Co., that owns 25% of Empanada Co., sold to Empanada an item of property, plant, and equipment having a five-year remaining life, at a gain of €100,000. Radnor Co. expects to remain in the 34% marginal tax bracket. The sale occurred at the end of 20XX-1; Empanada Co. will use straight-line depreciation to amortize the asset over the years 20XX through 20XX+4.

The entries related to the foregoing are:

*20XX-1*

1.	Gain on sale of property, plant and equipment	25,000	
	Deferred gain		25,000

*To defer the unrealized portion of the gain.*

2.	Deferred tax benefit	8,500	
	Income tax expense		8,500

*Tax effect of gain deferral.*

Alternatively, the 20XX-1 events could have been reported by this single entry.

	Equity in Empanada income	16,500	
	Investment in Empanada Co.		16,500

*20XX through 20XX+4 (each year):*

1.	Deferred gain	5,000	
	Gain on sale of property, plant and equipment		5,000

<i>To amortize deferred gain.</i>		
2. Income tax expense	1,700	
Deferred tax benefit		1,700
<i>Tax effect of gain realization.</i>		
The alternative treatment would be:		
Investment in Empanada Co.	3,300	
Equity in Empanada income		3,300

In the example above, the tax currently paid by Radnor Co. ( $34\% \times \text{€}25,000$  taxable gain on the transaction) is recorded as a deferred tax benefit in 20XX-1 since taxes will not be due on the book gain recognized in the years 20XX through 20XX+4. Under provisions of IAS 12, deferred tax benefits should be recorded to reflect the tax effects of all deductible temporary differences. Unless Radnor Co. could demonstrate that future taxable amounts arising from existing temporary differences exist, this deferred tax benefit might be offset by an equivalent valuation allowance in Radnor Co.'s statement of financial position at year-end 20XX-1, because of the doubt that it will ever be realized. Thus, the deferred tax benefit might not be recognizable, net of the valuation allowance, for financial reporting purposes unless other temporary differences not specified in the example provided future taxable amounts to offset the net deductible effect of the deferred gain.

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*NOTE: The deferred tax impact of an item of income for book purposes in excess of tax is the same as a deduction for tax purposes in excess of book.*

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This is discussed more fully in Chapter 26.

When downstream transactions provide evidence of a reduction in the net realizable value of asset to be sold or contributed, or of an impairment loss, the investor must recognize the full loss. Similarly, when upstream transactions provide evidence of a reduction in the net realizable value of the asset to be purchased, or of an impairment loss, the investor shall recognize its share in those losses.

### ***Contribution of non-monetary assets***

If an investee makes a contribution of a non-monetary asset that do not constitute a business, as defined in IFRS 3, to an associate or joint venture in exchange for an equity interest, the fair value of the asset is in principle capitalized as part of the investment. However, fair value gains and losses are only recognized by the investor to the extent of the unrelated investors' interest in the associate or joint venture. Any fair value profit or loss regarding the investee's share in the associate or joint venture is not recognized.

### **Accounting for Changes in Ownership Interest**

This section covers the accounting issues that arise when the investor either sells some or all of its equity or acquires additional equity in the investee. The consequence of these actions could involve discontinuation of the equity method of accounting, or resumption of the use of that method.

### ***Loss of significant influence***

Significant influence is lost when an investee loses the power to participate in the financial and operating policy decisions of the investee. The loss of significant influence does



not always occur with a change in absolute or relative ownership levels. The associate may for instance be subjected to the control of a government, court, administrator or regulator. Contractual arrangements could also change significant influence.

### ***Discontinuing the equity method***

The equity method is discontinued from the date when the investment ceases to be an associate or joint venture. Different situations may arise. If the investment changes to a subsidiary, IFRS 3, *Business Combinations*, is applied for the initial recognition of the subsidiary (Chapter 15).

If the retained interest becomes a financial instrument (not classified as a subsidiary, joint arrangement or associate) the retained interest should be measured at fair value and the fair value change recognized in profit or loss. The fair value on the date of discontinuance of the equity method becomes the initial recognition value of the financial instrument. The profit or loss is the difference between:

- The fair value of the retained interest and any proceeds from the sale of a part of the interest; and
- The carrying value of the investment on the date the equity method is discontinued.

When the equity method is discontinued, any equity share of the associate or joint venture recognized in other comprehensive income must be removed by regarding this as part of the sale of the transaction. The effect is that the gain and loss previously recognized in other comprehensive income is reclassified (as a reclassification adjustment) to profit or loss.

If an associate changes to a joint venture or a joint venture changes to an associate, the equity method is continued without any remeasurement of the retained interest.

If the interest in an associate or joint venture is reduced, but the equity method is still applied, a profit and loss is calculated on the portion sold as the difference between the proceeds received and the carrying value of the portion sold. Any proportionate profit or loss recognized in other comprehensive income that relates to the portion of the investment sold must also be reclassified to profit or loss.

#### **Example of accounting for a discontinuance of the equity method**

Assume that Plato Corp. owns 10,000 ordinary shares (30%) of Xenia Co. for which it paid €250,000 10 years ago. On July 1, 20XX, Plato sells 5,000 Xenia shares for €375,000. The balance in the Investment in Xenia Co. account at January 1, 20XX was €600,000. Assume that all the original differential between cost and book value has been amortized. To calculate the gain (loss) on the sale of 5,000 shares, it is necessary first to adjust the investment account so that it is current as of the date of sale. Assuming that the investee reported net profit of €100,000 for the six months ended June 30, 20XX, the investor should record the following entries:

1.	Investment in Xenia Co.	30,000	
	Equity in Xenia income (€100,000 × 30%)		30,000
2.	Income tax expense	2,040	
	Deferred tax liability (€30,000 × 20% × 34%)		2,040

The gain on sale can now be computed, as follows:

Proceeds on sale of 5,000 shares	€375,000
Book value of the 5,000 shares (€630,000 × 50%)	315,000
Gain from sale of investment in Xenia Co.	€ 60,000

Two entries will be needed to reflect the sale: one to record the proceeds, the reduction in the investment account, and the gain (or loss); the other to record the tax effects thereof. Recall that the investor must have computed the deferred tax effect of the undistributed earnings of the investee that it had recorded each year, on the basis that those earnings either would eventually be paid as dividends or would be realized as capital gains. When those dividends are ultimately received or when the investment is disposed of, the deferred tax liability recorded previously must be amortized.

The gains (losses) from sales of investee equity instruments should be reported in the investor's profit or loss as a separate line item after the line of its share of those joint ventures or associated profit or loss from continuing operations.

### ***Acquisition of an associate in stages***

An entity may hold an investment in another entity's ordinary share that is below the level that would create a presumption of significant influence, which it later increases so that the threshold for application of the equity method is exceeded. The guidance of IAS 28 would suggest that when the equity method is first applied, the difference between the carrying amount of the investment and the fair value of the underlying net identifiable assets must be computed (as described earlier in the chapter). Even though IFRS 39's fair value provisions were being applied, there will likely be a difference between the fair value of the passive investment (gauged by market prices for publicly-traded instruments) and the fair value of the investee's underlying net assets (which are driven by the ability to generate cash flows, etc.). Thus, when the equity method accounting threshold is first exceeded for a formerly passively held investment, determination of the "goodwill-like" component of the investment will typically be necessary.

### ***Increasing a stake in an associate while continuing the equity method***

When an entity increases its stake in an existing associate continuing to have significant influence but not gaining control, the cost of acquiring the additional stake (including any directly attributable costs) is added to the carrying value of the associate. Goodwill that arises from the purchase of the additional stake is calculated based on the fair value information at the date of the acquisition of the additional stake. The previously held interest may not be stepped up because the status of the investment has not changed. The same applies, for example, when existing stakes are reduced, thus resulting in an increased stake in an existing associate (e.g., where the investee purchases treasury shares from outside shareholders (i.e., owners other than the reporting entity)).

### ***Dilution losses***

A stake in an associate or joint venture may decrease, for example, following a capital increase on the part of the investee in which the investor does not take part. This constitutes a partial disposal of an entity's interest in an associate. Investor accounting for investee capital transactions that dilute the share of the investor's investment is not addressed by IAS 28. Although due to IFRS 10.B96 changes in the proportion held by non-controlling interests shall be recognized directly in equity, we feel that this principle is not applicable in this instance as the investor only accounts for his stake in the investee in his equity accounting and has not entered into a transaction with the associate. Accounting adjustments such as these therefore do not constitute transactions with owners, and any profit or loss must be recognized in the income statement.

### Example of accounting for an investee capital transaction

Assume that Roger Corp. purchases, on February 1, 20XX, 30% (2,000 shares) of Energetic Corp.'s outstanding shares for €1,000,000. The carrying amount held by Roger Corp. in Energetic Corp. is €1,000,000, including goodwill and fair value adjustments in respect of the identified assets and liabilities of Energetic Corp. On March 1, 20XX, Energetic Corp. raises its equity by €1,000,000 by means of a cash capital increase. Roger Corp. does not take part in this capital increase. As a result, the stake held by Roger Corp. in Energetic Corp. drops to 23%.

The loss suffered by Roger Corp. is calculated as follows:

Dilution of original stake  $(€1,000,000/30\% \times 7\%) = €233,333$

Stake in increased assets following cash capital increase  $(€1,000,000 \times 23\%) = €230,000$

Loss €3,333

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

### Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX

#### 20. Investments accounted for using the equity method

Name	Country of incorporation	Proportion of ownership interest		Proportion owned by associates and joint venture		Principal Activities	IFRS12 p20 p21
		20XX	20XX-1	20XX	20XX-1		
Associate A (a)	UK	16%	16%	–	–	Marketing of widgets	
Associate B (b)	UK	–	–	32%	32%	Property holding	
Joint Venture C	UK	33.3%	33.3%	–	–	Distribution	

- a) Associate A is an associate of the group even though the group only owns 16% interest in Associate A. Significant influence arises by virtue of the groups' contractual right to appoint three out of the seven board of directors of Associate A. IFRS12 p9
- b) Associate B has a year end of 30 November. This reporting date was established when the company was incorporated. The reporting date cannot change as it is not permitted by the government in the UK. IFRS12 p21 p22

Associate A's financial statements for the year ended 30 November 20XX have been used and appropriate adjustments have been made for the effects of any significant transactions that occurred between Associate A's year end the group's year end. This was necessary so as to apply the equity method of accounting. IFRS13 p97

Based on the quoted market price available on the UK stock exchange as at 31 December 20XX, the fair value of the group's interest in Associate A was £X.

#### Impairment of the Value of Equity Method Investments

An entity applies IAS 39, *Financial Instruments: Recognition and Measurement*, to determine if any investment in an associate or joint venture is impaired. IAS 39 is also used to determine if other interests in the associate or joint venture should be impaired. Since goodwill is included in the carrying value of the investment, it is not separately assessed for impairment. The total value of the investment is assessed in terms of IAS 39 and the goodwill portion is not assessed in terms of IAS 36, *Impairment* (see Chapter 13). However if IAS 39

indicates that an impairment is applicable, the total carrying value of the investment is compared to its recoverable amount (higher of value in use or fair value) determined in terms of IAS 36. Specifically, the impairment loss is not allocated to any individual asset, including goodwill. Instead, the total investment is impaired.

A reversal of an impairment loss is only applied when the recoverable amount of the investment increases.

In determining the value in use, an entity should consider:

1. Its share of the present value of the estimated future cash flows expected to be generated by the investee as a whole, including the cash flows from the operations of the investee and the proceeds on the ultimate disposal of the investment; or
2. The present value of the estimated future cash flows that are expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions (given a perfectly functioning capital market), both methods give the same result.

### **Other Requirements of IAS 28**

#### ***Separate financial statements***

IAS 28 provides that in the separate financials of the investor, the investment in the associate or joint venture may be carried at either cost, in terms of IAS 39 (or IFRS 9 once it becomes effective) or using the equity method as described in IAS 28. This is an accounting policy choice that the investor must make and apply consistently across each category of investments.

#### ***Consistency of accounting policies***

Financial statement should be prepared using uniform accounting policies. If the accounting policies of the associate or joint venture differ from the reporting entity, adjustments should be made to the financial statements of the associate or joint venture to conform to those of the reporting entity.

#### ***Coterminous year-end dates***

The most recent available financial statements of the associate or joint venture are used to apply the equity method. If the reporting dates of the entity and the associate or joint venture differ, financial statements on the reporting date of the entity are prepared for the associate or joint venture, unless it is impracticable to do so. If the reporting dates differ, adjustments are required for the effect of significant transactions that occur between the dates. IAS 28 requires that a reporting date difference of no more than three months is permissible. The length of the reporting period and difference in reporting dates must be applied consistently from year to year.

#### ***Treatment of cumulative preferred shares***

If an associate has outstanding cumulative preferred shares, held by parties other than the investor that are classified as equity, the investor computes its share of the profits or losses after deducting dividends due to the preferred shareholders, whether or not declared.

#### ***Share of losses exceeding the interest***

If an entity's share of losses exceeds its interest in the associate or joint venture, the recognition of its share of future losses is discontinued. The interest in the associate or joint

venture is the carrying amount of the equity accounted investment and other long-term interests that are regarding as part of the entity's net investment in the associate or joint venture. Long-term items for which settlement is neither planned nor likely to occur are deemed to be an extension of the investment. Losses incurred after the investment in associate or joint venture is reduced to zero are applied to other interests in reverse order of seniority (i.e., priority in liquidation).

If the entity's interest is reduced to zero, any further losses are only recognized as a liability to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture is again profitable, the entity only resumes recognizing its share of profits after the share of losses not recognized are eliminated.

## SEPARATE FINANCIAL STATEMENTS

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IAS 27, *Separate Financial Statements*, addresses issues related to accounting for investments in subsidiaries, joint ventures, and associates when the entity elects or is required by local regulations to prepare separate financial statements in accordance with IFRS. Separate financial statements are financial statements that are presented in addition to consolidated financial statements and financial statements of companies without subsidiaries but has investments in associates or joint ventures which are required by IAS 28 to be accounted by applying the equity method. Individual financial statements prepared by companies that do not have subsidiaries, associates or joint ventures are not separate financial statements. However, entities that are exempted from preparing consolidated financial statements or from applying equity accounting may present separate financial statements as their only financial statements. In addition, an investment entity that is required to apply the exception to consolidation for all of its subsidiaries by measuring these at fair value presents separate financial statements as its only financial statements.

An entity preparing its separate financial statements may account for investments in subsidiaries, joint ventures and associates either:

1. At cost; or
2. In accordance with IAS 39 (or IFRS 9 when it becomes effective); or
3. Using the equity method as described in IAS 28.

The possibility of using the equity method in separate financial statements was introduced by the amendments to IAS 27 ("Equity Method in Separate Financial Statements") in August 2014. An entity shall apply those amendments for annual periods beginning on or after January 1, 2016 retrospectively in accordance with IAS 8. Earlier application is permitted. If this option is chosen by the entity, it shall be disclosed. This Amendment had not yet been endorsed for IFRS users in the EU at the time of going to press. Endorsement by the EU is expected in the fourth quarter of 2015.

The same accounting should be applied for each category of investments presented in the separate financial statements. Investments accounted for at cost or using the equity method and classified as held-for-sale (or included in a disposal group that is classified as held-for-sale) are accounted for in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* (measured at fair value less costs to sell). Investments accounted for at fair value in accordance with IAS 39 (or IFRS 9) are excluded from IFRS 5's measurement requirements. Consequently, an entity should continue to account for such investments in

accordance with IAS 39 (or IFRS 9) even if they meet the held-for-sale criteria in IFRS 5. If an entity that is a venture capital or similar organization elects to account for its investments in associated and joint ventures at fair value in its consolidated financial statements, it must also use fair value in its individual financial statements.

An entity should recognize a dividend from a subsidiary, jointly controlled entity, or associate in profit or loss in its separate financial statements when it has the right to receive the dividend. The dividend is recorded in the profit or loss unless the equity method has been used. In this case the dividend has to be reduced from the carrying amount of the investment.

Special guidance is provided to determine cost in certain reorganizations if the cost option is applied in the separate financial statements. The guidance is applicable when a new entity is established meeting the following requirements:

1. The new parent obtains control of the original parent (or other entity) by issuing equity instruments in exchange for existing equity instruments.
2. The assets and liabilities of the new group and the original group (or entity) are the same before and after the reorganization.
3. The owners of the original parent (or other entity) before the reorganization maintain the same absolute and relative interest in the net assets of the group before and after the reorganization.

### ***Investment entities***

Although investment entities present separate financial statements as their only financial statements, the cost option is not available to investment entities, since these would have to measure their investments at fair value through profit or loss. When an entity ceases to be an investment entity, it is required to consolidate any subsidiaries under IFRS 10. Should it continue to present separate financial statements in addition to consolidated financial statements, the cost option or the equity method will become available to it as with any other entity, subject to the requirements discussed above. The date of the change of status shall be the deemed acquisition date. The fair value of any subsidiary at the date of change in status becomes the deemed consideration of the subsidiary in the separate financial statements, when accounting for the investments in accordance with the options showing above. If an entity becomes an investment entity, the difference between the previous carrying amount of the subsidiary and its fair value at the date of the change of status of the entity is recognized as a gain or loss in profit or loss. The cumulative amount of any gain or loss previously recognized in other comprehensive income in respect of those subsidiaries must be treated as if the investment entity had disposed of those subsidiaries at the date of change in status.

### ***Disclosure in separate financial statements***

All applicable IFRSs are applied in the separate financial statements. Additionally, when a parent (because of the exemption in IFRS 10) elects not to prepare consolidated financial statements and instead prepares separate financial statements, the following should be disclosed in those separate financial statements:

- The fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and principal place of business (and country of incorporation if different) of the entity whose consolidated

financial statements that comply with IFRS have been produced for public use; and the address where those consolidated financial statements are obtainable;

- A list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, principal place of business (and country of incorporation if different), proportion of ownership interest and, if different, proportion of voting rights; and
- A description of the method used to account for the foregoing investments.

When a parent (other than a parent covered by the above mentioned exemption) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the parent or investor is required to identify the financial statements prepared in accordance with IFRS 10, IFRS 11 or IAS 28 to which they relate. The parent or investor must also disclose the following in its separate financial statements:

- The fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;
- A list of significant investments in subsidiaries, jointly controlled entities, and associates, including the name, principal place of business (and country of incorporation if different), proportion of ownership interest and, if different, proportion of voting rights; and
- A description of the method used to account for the foregoing investments.

## DISCLOSURE REQUIREMENTS

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IFRS 12, *Disclosure of Interest in Other Entities*, combines the disclosure about an entity's interest in subsidiaries, joint arrangements, associates and unconsolidated "structured entities" in one standard. IFRS 12 does not apply to employee benefit plans, separate financial statements (except in relation to unconsolidated structured entities), participants in joint ventures that do not share in joint control, and investments accounted for in accordance with IAS 39, except for interests in associates, joint ventures, or unconsolidated structured entities measured at fair value.

IFRS 12 specifically provides disclosure requirements for structured entities that are not consolidated to identify the nature and risk associated with them. A structured entity is an entity that has been designated so the voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. The main features or attributes of structured entities could include:

- Restricted activities;
- A narrow and well-defined objective;
- Insufficient equity to finance its activities without subordinated financial support; and
- Financing in the form of multiple contractually linked instruments to investors that creates concentration of credit risks and other risks.

The disclosures in IFRS 12 are presented as a series of objectives, with detailed guidance on satisfying those objectives. The detailed guidance satisfying these objectives is quite extensive and, for the reader's convenience, is presented in detail in the disclosure checklist in Appendix A to this publication. The objectives are listed below. An entity needs to consider the level of detail needed to meet these objectives and should not only apply the checklist as a means of achieving

the minimum requirements. In July 2015 the IASB clarified the disclosure requirements by specifying that the disclosure requirements in IFRS 12, other than those in paragraphs B10–B16, apply to interests that are classified as held-for-sale or discontinued operations in accordance with IFRS 5. This amendment will be included in the Exposure Draft Annual Improvements to IFRS 2014–2016 Cycle and it will be proposed that the proposal should be applied retrospectively.

### ***Main objective***

The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate:

- The nature of, and risks associated with, its interests in other entities;
- The effects of those interests on its financial position, financial performance and cash flows.

Where the disclosures required by IFRS 12, together with the disclosures required by other IFRSs, do not meet the above objectives, an entity is required to disclose whatever additional information is necessary to meet the objectives.

### ***Significant judgements and assumptions***

An entity discloses information about significant judgements and assumptions it has made (and changes in those judgements and assumptions) in determining whether:

- It controls another entity;
- It has joint control of an arrangement or significant influence over another entity;
- The type of joint arrangement (i.e., joint operation or joint venture) when the arrangement has been structured through a separate vehicle;
- It meets the definition of an investment entity, if applicable.

### ***Interests in subsidiaries***

An entity must disclose information that enables users of its consolidated financial statements to:

- Understand the composition of the group;
- Understand the interest that non-controlling interests have in the group's activities and cash flows;
- Evaluate the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
- Evaluate the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- Evaluate the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control;
- Evaluate the consequences of losing control of a subsidiary during the reporting period.

### ***Interests in joint arrangements and associates***

An entity must disclose information that enables users of its financial statements to evaluate:

- The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the



other investors with joint control of, or significant influence over, joint arrangements and associates;

- The nature of, and changes in, the risks associated with its interests in joint ventures and associates.

#### ***Interests in unconsolidated structured entities***

An entity must disclose information that enables users of its financial statements to:

- Understand the nature and extent of its interests in unconsolidated structured entities;
- Evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

#### ***Investment entities***

An investment entity is required to disclose information about significant judgements and assumptions it has made in determining that it is an investment entity. If the investment entity does not have one or more of the typical characteristics of an investment entity, it must disclose its reasons for concluding that it is nevertheless an investment entity. In addition, an investment entity is required to disclose the following information, in addition to any disclosures required by other standards (such as IFRS 7 or IAS 24):

- The effects of changes in investment entity status;
- The composition of the group;
- The nature and extent of any significant restrictions;
- Any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary;
- Details of any sponsorship of unconsolidated subsidiaries;
- Terms of any contractual arrangements to provide support to unconsolidated subsidiaries).

## **TRANSITION GUIDANCE**

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The suite of five standards (IFRS 10, IFRS 11, IFRS 12, IAS 27 [amended] and IAS 28 [amended]) is applicable for periods beginning on or after January 1, 2013. For entities preparing financial statements in accordance with IFRS as adopted by the EU, the suite of five is effective for periods beginning on or after January 1, 2014. Earlier application is permitted provided that the fact is disclosed and all five standards are applied simultaneously. These standards are applied retrospectively, except for the relief provided as discussed below. Entities are only required to provide disclosure of the quantitative information required by IAS 8 for the immediately preceding reporting period.

#### ***Consolidations***

At the date of initial application (the beginning of the annual period IFRS 10 is applied for the first time) no adjustments are required to the previous accounting for entities that are consolidated based on the old IAS 27 and, in terms of IFRS 10, will still be consolidated. Relief is also provided for an investor's interest in investees that were disposed of during the previous reporting period resulting in non-consolidation in terms of both the old IAS 27 and IFRS 10.

If the consolidation conclusion is different on the date of initial application, IFRS 10 clarifies how the retrospective application should be applied. If IFRS 10 results in the consolidation of an entity not previously consolidated, the retrospective application differs depending on whether the investee is a business (as defined for business combination purposes see Chapter 15) or not. If the investee is a business, the assets, liabilities and non-controlling interest of the previously unconsolidated entity is measured by application of the acquisition method of IFRS 3 from the date control of the investee is obtained in terms of IFRS 10. The investor only retrospectively adjusts the immediately preceding reporting period. When the date on which control was obtained was before the beginning of the immediately preceding reporting period, equity at the beginning of the immediately preceding reporting period should be adjusted with the difference between the amount of assets, liabilities and non-controlling interest recognized and the previous carrying amount of the investor's investment.

If, however, the investee is not a business, no goodwill is recognized for the transaction in terms of IFRS 3. The immediately preceding reporting period is also retrospectively adjusted. When the date on which control was obtained was before the beginning of the previous reporting period, equity at the beginning of that period is adjusted with the difference between the amount of assets (excluding goodwill), liabilities, and non-controlling interest recognized and the previous carrying amount of the investor's investment.

If it is impracticable to measure the investee's assets, liabilities and non-controlling interest, different guidance is also provided for businesses and non-businesses. In the case of a business, IFRS 3 is applied from the deemed acquisition date. The deemed acquisition date is the beginning of the earliest period the application of IFRS 3 is practicable, which could be the current period. The same principles apply for non-businesses, except that goodwill is not calculated. If the current period is the earliest period that the application of IFRS 3 is practicable, the adjustment to equity is only made at the beginning of the current period.

Application of IFRS 3 to account for the acquisition of control as described above depends on when control was obtained. If the acquisition date precedes the effective date of IFRS 3 (2008 version), the entity has the choice to either apply IFRS 3 (2004 version) or IFRS 3 (2008 version) to account for the business combination. If the acquisition date is after the effective date of IFRS 3 (2008), then that is the standard that must be applied. Refer to Chapter 15.

If IFRS 10 results in the non-consolidation of an entity that was previously consolidated, the investment in the investee is measured at the amount it should have been measured as if IFRS 10 was applicable at the date of acquisition of the investment or when control was previously lost. The results of the previous reporting period are adjusted retrospectively. If the date the investment was acquired or control was lost is before the beginning of the previous reporting period, equity is adjusted at the beginning of the previous reporting period as the difference between the previous carrying amount of the assets, liabilities, and non-controlling interest and the recognized amount of the investment. The impracticability guidance discussed above is also applicable in this instance.

### ***Joint venture***

When the accounting of a joint venture is changed from proportionate consolidation to the equity method, the investment is recognized from the beginning of the previous reporting period. On that date the investment is measured at the aggregate of the asset and liabilities (including goodwill) recognized in terms of the proportionate consolidation method. This

becomes the deemed cost on initial recognition. The deemed cost should, however, be assessed for impairment, and any impairment loss adjusts the opening retained earnings at that date. If the aggregate of the assets and liabilities recognized in terms of proportionate consolidation results in a negative net asset, a corresponding liability shall only be recognized if the entity has a legal or constructed liability for such an amount. If not, retained earnings is adjusted and the fact of non-recognition of the liability and the entity's share in the cumulative unrecognized losses of the joint venture must be disclosed. The entity also discloses the breakdown of the assets and liabilities aggregated into the one-line investment.

### ***Joint operation***

When a joint operation is changed from the equity method to accounting for assets and liabilities, the entity derecognizes the investment at the beginning of the previous reporting period and any other items that form part of its net investment in the joint operation. The entity's share of the assets and liabilities (including goodwill included in the equity investment) of the joint operation is recognized in accordance with the contractual arrangement and based on the information used for application of the equity method. Any difference between the assets and liabilities recognized and the net investment derecognized is first offset against goodwill, if it represents a credit balance. Any balance remaining or debit balance is recognized in retained earnings. A reconciliation should be provided between the investment derecognized and the assets and liabilities recognized, identifying the amount recognized in retained earnings.

An entity that previously accounted for its interest in a joint operation at cost in its separate financial statements is required to derecognize the investment and recognize its share of the assets and liabilities of the joint operation. Similarly, a reconciliation should be provided between the amounts by identifying the amount recognized in retained earnings.

### ***Investment entities***

At the date of initial application of the amendments to IFRS 10, IFRS 12 and IAS 27, an entity must assess whether it is an investment entity on the basis of the facts and circumstances that exist at that date. If, at the date of initial application, an entity concludes that it is an investment entity, it will retrospectively measure its investment in each subsidiary at fair value through profit or loss as if the investment entity principles had always been effective.

### ***Disclosure***

The disclosure requirements of IFRS 12 are not required to be applied for any period presented before the immediately preceding reporting period. Comparative disclosures of unconsolidated structured entities are also not required for the immediately preceding period in the period of initial application.

## **FUTURE DEVELOPMENTS**

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At its June 2015 meeting the IASB decided to suspend work on a narrow-scope amendment to IFRS 10, *Consolidated Financial Statements* and IAS 28, *Associates and Joint Ventures* and, instead, decided to address those issues as part of the research project on the equity method of accounting. It also decided to postpone the effective date of a related amendment "Sale or Contribution of Assets between an Investor and its Associate or Joint Venture," that was completed and issued in September 2014, (the "September 2014

Amendment”) to prevent the requirements of IAS 28 being changed twice within a short space of time. The effective date of this amendment has been deferred for an indefinite time. Originally the effective date was January 1, 2016. Despite of the deferral of the effective date, the IASB wants to finalize the proposal before the effective date, i.e., January 1, 2016. This amendment deals with gains and losses resulting from a downstream transaction involving assets that constitute a business, as defined in IFRS 3, between an entity (including its consolidated subsidiaries) and its associate or joint venture. It is proposed that this gain or loss has to be recognized in full in the investor’s financial statements.

## US GAAP COMPARISON

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Although the IFRS 10 consolidation project was a joint project with the FASB, the FASB has not issued the related proposed changes. Changes introduced by IFRS 10, IFRS 11 and IFRS 12 are not incorporated into US GAAP. The basic consolidation and equity accounting principles, however, remain the same.

US GAAP requires preparation of consolidated financial statements, with certain industry-specific exceptions. US GAAP also contains certain quantitative thresholds regarding investment at risk for stakeholders that impact requirements to consolidate entities. Certain leases with a company whose primary purpose is to lease property back to a company under certain circumstances must be consolidated. US GAAP permits different reporting dates for the parent and subsidiary up to three months, but only if the use of the same reporting date is impracticable. The effects of significant events between the dates must be disclosed. US GAAP does not require uniform accounting policies within the group.

Under US GAAP consolidation of entities is based on a controlling financial interest model, which includes a variable interest entity (VIE) model and, if the VIE model is not applicable, a voting interest model. Under the VIE model, a reporting entity has a controlling financial interest in a VIE if it has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and the obligation to absorb losses or the rights to receive benefits from the VIE. According to the voting interest model, a controlling financial interest generally exists if a reporting entity has continuing power to govern the financial and operating policies of an entity. In assessing control, substantive kick-out rights are sometimes viewed differently under US GAAP. Under US GAAP the concept of “de facto control” does not exist.

Under US GAAP, like IFRS, control of a VIE is evaluated on a continuous basis; however, under US GAAP, control of a non-VIE is reassessed only when there is a change in the voting interest of the investee.

In a business combination, US GAAP requires non-controlling interest (NCI) to be recorded at fair market value, whereas under IFRS there is an option to record NCI at its proportionate interest in the net assets or at fair market value.

In the case of the loss of control, under US GAAP, all amounts recognized in accumulated OCI are reclassified.

Push down accounting is required in certain circumstances for public companies and optional for private companies under US GAAP. Push down accounting is not allowable under IFRS.

For equity method investments under US GAAP, potential voting rights are not considered when determining significant influence. Entities have the option to account for equity-method investees at fair value. If fair value is not elected, and significant influence

exists, the equity method of accounting is required. Uniform accounting policies between investor and investee are not required.

Under US GAAP, the carrying amount of an equity-method investee is written down only if the impairment can be deemed as “other than temporary.” US GAAP provides also specific guidelines on changes in the status of an equity-method investee.

Under US GAAP, there is no definition of a “joint arrangement” and of a “joint operation.” Unlike IFRS the definition of a “joint venture” refers to a jointly controlled activity. Joint ventures defined as in accordance to IFRS are generally accounted under US GAAP using the equity method of accounting, unless the fair value option is elected. Proportionate consolidation is permitted in limited circumstances to account for interests in unincorporated entities where it is an established practice in a particular industry.

Under US GAAP, unlike IFRS which only permits fair value accounting of an investment company investee if the parent is itself an investment company, investments in investment entities are always accounted for at fair value if the investee meets the characteristics of an investment company. These characteristics are very similar to IFRS. This is because the FASB and IASB undertook a joint project in 2011 to more closely align the accounting for investment entities.

non-controlling interests. The revised standards are a result of the second phase of the Business Combinations project, conducted jointly with the US Financial Accounting Standards Board (FASB), to improve financial reporting while promoting the international convergence of accounting standards. Revised IFRS 3 and IAS 27 will be denoted as IFRS 3 (R) and IAS 27(R) in this chapter, for the sake of clarity, although these are not the official titles of the standards.

The first phase of the Business Combinations project, which FASB and IASB deliberated separately, concluded with the FASB issuing FAS 141, *Business Combinations*, in 2001, and the IASB issuing the original version of IFRS 3, *Business Combinations*, in 2004. Their primary conclusion in that first phase of the project was that since virtually all business combinations involve the acquisition of one entity by another, only one method of accounting for business combinations is warranted—which was denoted as the purchase method. Consequently, IFRS 3 ended the use of pooling-of-interests accounting, and treats goodwill arising from an acquisition as an intangible asset with an indefinite life, not subject to periodic amortization, but instead to be tested periodically for impairment. IFRS 3 also requires that, where there is a non-controlling interest (formerly, minority interest), the assets and liabilities in a subsidiary are to be valued at full fair value, including the non-controlling interest's portion. (Under US GAAR before the recent changes made by ASC 805, the non-controlling interest was to be valued at book value, but now it has to be presented at fair value).

IFRS had traditionally permitted two distinct methods of accounting for business combinations. The purchase accounting method required that the actual cost of the acquisition be recognized, including any excess over the amounts allocable to the fair value of identifiable net assets, commonly known as goodwill. The pooling-of-interests method, available only when a set of stringent criteria were all met, resulted in combining the book values of the merging entities, without any adjustment to reflect the fair values of acquired assets and liabilities, and without any recognition of goodwill. Since pooling-of-interests accounting required that the mergers be achieved by means of exchanges of ordinary (common) shares, the use of this method was largely restricted to publicly held acquirers, which greatly preferred poolings since this averted step-ups in the carrying value of depreciable assets and goodwill recognition, the amortization of which would reduce future reported earnings.

IFRS 3 contained significant differences from the then-effective US GAAP standards (FAS 141 and ASC 350), and both the IASB and the FASB believed their respective standards could be improved and converged. Consequently the Boards conducted jointly the second phase of the Business Combination project to converge their respective standards, which resulted in the current versions of both standards, each of which provide guidance for applying the acquisition method of accounting for business combinations. This second phase culminated with the issuance of the revised IFRS 3(R) and IAS 27(R), which were effective prospectively for business combinations for which the acquisition date was on or after the beginning of the first annual reporting period beginning on or after July 1, 2009. While the revised IFRS more closely resemble the equivalent US GAAP standards, differences still remain. Accountants who are responsible for preparing financial statements using both sets of standards or who are responsible for reconciling or converting financial statements must be cognizant of these differences.

IFRS 3(R) and IAS 27(R) introduced a number of changes in accounting for business combinations and preparation of consolidated financial statements. These changes will

impact the amounts of goodwill and non-controlling interest recognized, and operating results in the year that acquisition occurs and future years. In accordance with the revised standards, entities will have a choice for each business combination entered into to measure non-controlling interest in the acquiree either at its full fair value or at its proportionate share of the acquiree's identifiable net assets. This choice will result in either recognizing goodwill relating to 100% of the business (applying the full fair value option and allocating implied goodwill to non-controlling interest) or recognizing goodwill relating only to the percentage interest acquired.

In accordance with IFRS 3(R) and IAS 27(R), all business combinations are accounted for as an acquisition. The assets acquired and liabilities assumed are recorded in the acquirer's books at their respective fair values using *acquisition accounting* (which should be distinguished from the formerly prescribed method, *purchase accounting*). Goodwill is measured initially as the difference between (1) the acquisition-date fair value of the consideration transferred plus the fair value of any non-controlling interest in the acquiree, plus the fair value of the acquirer's previously held equity interest in the acquiree, if any; and (2) the acquisition-date fair values (or other amounts recognized in accordance with IFRS 3(R) of the identifiable assets acquired and liabilities assumed. Goodwill can arise only in the context of a business combination, and cannot arise from purchases of an asset or group of assets.

The core principles adopted in IFRS 3(R) are that an acquirer of a business recognizes assets acquired and liabilities assumed at their acquisition-date fair values, and discloses information that enables users to evaluate the nature and financial effects of the acquisition. While fair values of many assets and liabilities can readily be determined (and in an arm's-length transaction should be known to the parties), certain recognition and measurement problems do inevitably arise. Among these are the value of contingent consideration (for example, earn-outs) promised to former owners of the acquired entity, and the determination as to whether certain expenses that arise by virtue of the transaction, such as those pertaining to elimination of duplicate facilities, should be treated as part of the transaction or as an element of post-acquisition accounting.

This chapter addresses in detail the application of the acquisition method of accounting for business combinations and, to a lesser extent, the accounting for goodwill. Chapter 11 presents the accounting for all intangible assets, including goodwill, with greater specificity. This chapter addresses the two allowed options of measuring non-controlling interest in the acquiree under IFRS 3(R):

1. The option to measure a non-controlling interest at its fair value and to allocate implied goodwill to the non-controlling interest; and
2. The option to measure the non-controlling interest at its proportionate share of the acquiree's identifiable net assets (which was the only option allowable under previous IFRS 3).

Consolidation of many "Special-Purpose Entities" (SPEs) has increased substantially under these requirements, which were in part spurred on by the financial reporting scandals of the early 2000s. Rules governing consolidation of SPEs are complex and are continuing to evolve further in response to the recent financial crisis.

The IASB previously issued a new standard on consolidation, IFRS 10, *Consolidated Financial Statements*, which addresses the basis on which a parent entity should consolidate its investments in subsidiaries and requires enhanced disclosures about consolidated and

non-consolidated entities. The new standard is effective for all financial periods commencing on or after January 1, 2013, and was issued in response to the need for a single IFRS on consolidation that would replace IAS 27, *Consolidated and Separate Financial Statements*, and SIC-12, *Consolidation—Special-Purpose Entities*. IAS 27 was amended as a result of the issuance of IFRS 10 and is now called IAS 27, *Separate Financial Statements*, and as the name implies, deals only with the accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present separate financial statements. IFRS 10 is worded in such a manner that it provides more rigorous guidance on the concept of control, which is built on the principles and definitions established in both IAS 27(R) and SIC 12. The result is a revision of the definition of control that can be applied to all legal entities. SIC 12 was superseded with the introduction of IFRS 10. The new standard also addresses the accounting that follows from a scenario where control might exist despite the “holding” company having control over less than a majority of the voting rights, potential voting rights, veto rights, and economic dependence. The standard also addresses the consolidation of structured entities (for example, SPEs) which are utilized for “off the books” financings, leasing activities, and other purposes. The objective is to force adherence to the “substance over form” practice of consolidating SPEs when they are, effectively, economically integrated with the reporting entity.

Major accounting issues affecting business combinations and the preparation of consolidated or combined financial statements pertain to the following:

1. The proper recognition and measurement of the assets and liabilities of the combining entities;
2. The accounting for goodwill or gain from a bargain purchase (negative goodwill);
3. The elimination of intercompany balances and transactions in the preparation of consolidated financial statements; and
4. The manner of reporting the non-controlling interest.

The IFRS 10 standard is discussed in further detail within Chapter 14.

The accounting for the assets and liabilities of entities acquired in a business combination is largely dependent on the fair values assigned to them at the transaction date (the now-obsolete pooling method relied upon book values). The US GAAP standard, FAS 157 (ASC 820), *Fair Value Measurements*, introduced a framework for measuring fair value, and its provisions provide important guidance when assigning values as part of a business combination. In essence, it favours valuations determined on the open market, but allows other methodologies if open market valuation is not practicable. The IASB added this topic to its agenda in September 2005 and decided to use the US standard as the starting point for its own deliberation. In November 2006, the IASB issued a Discussion Paper, and in May 2009 the Exposure Draft, *Fair Value Measurement*, was published. A final standard, IFRS 13, *Fair Value Measurement*, was issued in May 2011. It is aimed at establishing clear and consistent guidance for the measurement of fair value and also addressing valuation issues that arise in inactive markets. The fair value concepts and procedures are discussed in greater detail within Chapter 25.

#### Sources of IFRS

*IFRS 3(R)*

*IAS 27(R)*, 36, 37, 38

*SIC 32*

*IFRIC 5*, 10



## DEFINITIONS OF TERMS

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**Accounting consolidation.** The process of combining the financial statements of a parent company and one or more legally separate and distinct subsidiaries as a single economic entity for financial reporting purposes.

**Acquiree.** One or more businesses in which an acquirer obtains control in a business combination.

**Acquirer.** An entity that obtains control over the acquiree. When the acquiree is a special-purpose entity (SPE), the creator or sponsor of the SPE (or the entity on whose behalf the SPE was created) may be deemed to be the acquirer.

**Acquisition.** A business combination in which one entity (the acquirer) obtains control over the net assets and operations of another (the acquiree) in exchange for the transfer of assets, incurrence of liability, or issuance of equity.

**Acquisition date.** The date on which control of the acquiree is obtained by the acquirer (i.e., the date of exchange effecting the acquisition).

**Acquisition method.** The method of accounting for each business combination under IFRS. Applying the acquisition method requires:

1. Identifying the acquirer;
2. Determining the acquisition date;
3. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree; and
4. Recognizing and measuring goodwill or a gain from a bargain purchase.

**Acquisition-related costs.** Costs incurred by an acquirer to enter into a business combination.

**Asset.** A present economic resource:

1. Controlled by an entity, through an enforceable right or other means, as a result of past events; and
2. From which future economic benefits are expected to flow to the entity (*Framework*, IAS 38).

In addition, the asset must be capable of being measured reliably.

**Bargain purchase.** A business combination in which the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with IFRS 3(R), exceeds the aggregate of the acquisition-date fair value of the consideration transferred, plus the amount of any non-controlling interest in the acquiree, plus the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

**Business.** An integrated set of assets and activities capable of being conducted and managed in order to provide a return directly to investors or other owners, members, or participants. The return can be in the form of dividends, lower costs, or other economic benefits. A development stage enterprise is not precluded from qualifying as a business under this definition, and the guidance that accompanies it is provided in IFRS 3(R) (Appendix B).

**Business combination.** A transaction or other event that results in an acquirer obtaining control over one or more businesses. Transactions that are sometimes referred to as "true mergers" or "mergers of equals" are also considered to be business combinations with an acquirer and one or more acquirees.

**Closing date.** The day on which an acquirer legally transfers consideration, acquires the assets, and assumes the liabilities of an acquiree.

**Consideration transferred.** The acquirer measures the consideration transferred in a business combination in exchange for the acquiree (or control of the acquiree) at fair value, which is calculated as the aggregate of the acquisition-date fair values of the assets transferred, liabilities incurred to former owners of the acquiree, and the equity interests issued by the acquirer. The acquisition-date fair value of contingent consideration should also be recognized as part of the consideration transferred in exchange for the acquiree. Acquisition-related costs are expenses recognized when incurred in profit or loss.

**Consolidated financial statements.** The financial statements of a group (a parent and all its subsidiaries) presented as those of a single economic entity.

**Contingency.** An existing, unresolved condition, situation or set of circumstances that will eventually be resolved by the occurrence or non-occurrence of one or more future events. A potential gain or loss to the reporting entity can result from the contingency's resolution.

**Contingent consideration.** Generally, an acquirer's obligation to transfer additional assets or equity interests to the acquiree's former owners if specified future events occur or conditions are met. The contingent obligation is incurred as part of a business combination in order to obtain control of an acquiree. Contingent consideration might also arise when the terms of the business combination provide a requirement that the acquiree's former owners return previously transferred assets or equity interests to the acquirer under certain specified conditions.

**Control.** The power to govern the financing and operating policies of an entity so as to obtain benefits from its activities and increase, maintain, or protect the amount of those benefits. Control of an entity can be obtained either by:

1. Obtaining ownership of a majority of its outstanding voting power; or
2. Obtaining contractual rights to receive the majority of the financial benefits and/or by assuming contractual obligations to bear the majority of the financial consequences that occur in the future from the entity outperforming or underperforming its expectations (the controlled entity being referred to as a special-purpose entity, or SPE).

**Cost method.** A method of accounting whereby the investment is recognized at cost. The investor recognizes income from the investment only to the extent that the investor receives distributions.

**Creator (or sponsor) of SPE.** The entity on whose behalf a special-purpose entity (SPE) was created and which retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.

**Equity interests.** For the purposes of IFRS 3(R), the term, *equity interests*, is used broadly to mean ownership interests (or instruments evidencing rights of ownership) of investor-owned entities. In a mutual entity, equity interests means instruments evidencing ownership, membership, or participation rights.

**Fair value.** The amount for which an asset could be exchanged, or a liability settled in an orderly transaction between market participants at the measurement date.

**Favourable contract.** From the perspective of a counterparty, a contract is favourable if its terms are more lucrative than current market terms.

**Gain from a bargain purchase.** In a business combination resulting in a bargain purchase, the difference between:

1. The acquisition-date fair values (or other amounts measured in accordance with IFRS 3(R)) of the identifiable assets acquired and liabilities assumed; and

2. The acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest in the acquiree plus the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

A gain from a bargain purchase is recognized when (1) exceeds (2). Goodwill arises when (2) exceeds (1). After the acquirer's reassessment of whether all the assets acquired and all the liabilities assumed have been correctly identified, the resulting gain from a bargain purchase is recognized in profit or loss on the acquisition date. A gain from a bargain purchase is also referred to in accounting literature as negative goodwill.

**Goodwill.** An intangible asset acquired in a business combination representing the future economic benefits expected to be derived from the business combination that are not allocated to other individually identifiable and separately recognizable assets acquired. In accordance with IFRS 3(R), the acquirer measures goodwill initially as the difference between:

1. The acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest in the acquiree plus the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and
2. The acquisition-date fair values (or other amounts measured in accordance with IFRS 3(R)) of the identifiable assets acquired and liabilities assumed.

Goodwill is recognized when (1) exceeds (2). A bargain purchase arises when (2) exceeds (1). After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Entities have a choice for each business combination to measure non-controlling interest in the acquiree either at its fair value (and recognizing goodwill relating to 100% of the business) or at its proportionate share of the acquiree's net assets.

**Group.** A parent and all its subsidiaries.

**Identifiable asset.** An asset is identifiable if it either:

1. Is separable from the entity that holds it; or
2. Represents a legal and/or contractual right.

An asset is considered separable if it is capable of being separated or divided from the entity that holds it for the purpose of the asset's sale, transfer, license, rental, or exchange, by itself or together with a related contract, or other identifiable asset or liability, irrespective of whether management of the entity intends to do so. A legal and/or contractual right is considered identifiable irrespective of whether it is transferrable or separable from the entity or from other rights and obligations.

**Intangible asset.** An identifiable non-monetary asset that lacks physical substance.

**Leveraged buyout (LBO).** A single transaction or series of transactions in which a controlling interest in the stock of a target entity is acquired from the target's owners by a financial sponsor entity often organized as a private-equity limited partnership. A LBO transaction may be structured in a variety of ways, but is typically characterized by the incurrence by the acquirer of a substantial amount of non-recourse debt that is collateralized by the underlying assets of the acquiree. Thus, the acquiree's own assets provide the underlying collateral to the lenders, and the post-acquisition operating cash flows expected to be generated by the acquiree are intended to provide the funding necessary to meet the debt service requirements. When a LBO meets its initial expectations, it can result in a substantial return on a relatively minimal initial investment by the sponsor/acquirer's

investors. However, when the post-acquisition activities of the acquiree do not meet the initial expectations, the potential for a default on the acquisition indebtedness is substantial and the previously successful target can end up in reorganization or outright liquidation.

**Liability.** A present unconditional economic obligation, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (IAS 37, *Framework*).

The following three characteristics must be present for an item to qualify as a liability:

1. An economic obligation is expected to result in cash outflows, or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.
2. Obligations are enforceable against the entity by legal or other means and cannot be avoided.
3. The economic obligation exists at the reporting date as a result of a past event (Conceptual Framework Project).

In addition, liabilities are recognized subject to the constraint that the amount at which the settlement will take place can be measured reliably.

**Market participants.** Buyers and sellers in the principal or most advantageous market for an asset or liability who are:

1. Independent of the reporting entity (i.e., they are not related parties);
2. Knowledgeable to the extent that they have a reasonable understanding about the asset or liability and the transaction based on all available information, including information that is obtainable through the performance of usual and customary due diligence efforts;
3. Able to buy or sell the asset or liability;
4. Willing to enter into a transaction for the asset or liability (i.e., they are not under duress that would force or compel them to enter into the transaction).

**Mutual entity.** An entity that is not investor-owned, organized for the purpose of providing dividends, reduced costs, or other economic benefits directly to its owners, members, or participants. Examples of mutual entities include mutual insurance companies, credit unions and cooperative entities.

**Non-controlling interest.** The equity (net assets) in a subsidiary not directly or indirectly attributable to its parent. In accordance with IFRS 3(R), entities have a choice for each business combination entered into to measure non-controlling interest in the acquiree either (1) at its fair value, or (2) at its proportionate share of the value of the identifiable assets and liabilities (net assets) of the acquiree, measured as required by that standard. The first choice will result in recognizing goodwill constituting all of the goodwill of the acquired business (applying the fair value option and allocating implied goodwill to non-controlling interest), while the second choice will result in recognizing goodwill associated with only the percentage of interest acquired. Non-controlling interests were formerly referred to in accounting literature as minority interests.

**Owners.** For the purposes of IFRS 3(R), the term, *owners*, is used broadly to include holders of equity interests (ownership interests) in investor-owned or mutual entities. Owners include parties referred to as shareholders, partners, proprietors, members or participants.

**Parent.** An entity that has one or more subsidiaries.

**Reporting entity.** An entity for which there are users who rely on the entity's general-purpose financial statements as their major source of financial information about the entity

that will be useful to them for making decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.

**Reverse acquisition.** An acquisition when one entity, nominally the acquirer, issues so many shares to the former owners of the target entity that they become the majority owners of the successor entity.

**Reverse spin-off.** A spin-off transaction in which the nominal or legal spinor is to be accounted for as the spinnee, in order to reflect the economic reality of the spin-off transaction.

**Roll-up or put-together transaction.** A business combination that is effected by two or more entities transferring the net assets of their businesses to a newly formed entity. These transactions can also be effected by the owners of the entities transferring their equity interests in those entities to the newly formed entity.

**Separate financial statements.** The financial statements presented by a parent, an investor in an associate or a venture in a jointly controlled entity, in which the investments are accounted for on the basis of the direct interest rather than on the basis of the reported results and net assets of the investees. An entity accounts for such investments either (1) at cost; or (2) in accordance with IAS 39; or (3) in accordance with IFRS 9, *Financial Instruments* (for those entities who have adopted IFRS 9); or (4) using the equity method as described in IAS 28, *Investments in Associates and Joint Ventures*. IASB published “Equity Method in Separate Financial Statements (Amendments to IAS 27) which reinstates the equity method as an accounting option for investments in subsidiaries, joint ventures and associates in an entity’s separate financial statements. The amendments are effective for annual periods beginning on or after January 1, 2016, with earlier application permitted.

**Special-purpose entity (SPE).** An entity created to accomplish a narrow and well-defined objective (for example, to effect a lease, research and development activities, or a securitization of financial assets), which can be a corporation, trust, partnership or unincorporated entity. IFRS 10 requires consolidation when the SPE is controlled by the reporting entity (the sponsor or creator of the SPE). Under IFRS 3(R), this party is also referred to as a “parent” and the SPE is also referred to as a “subsidiary.”

**Spin-off.** The creation of an independent entity through the sale or distribution of new shares of an existing business/division of a parent company. For example, occasionally an entity may dispose of a wholly or partially owned subsidiary, or of an investee, by transferring it unilaterally to the entity’s shareholders.

**Stapling arrangement.** An arrangement in which two or more legal entities contractually agree to combine their securities so that they are quoted at a single price and cannot be traded or transferred independently.

**Subsidiary.** An entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

**Unfavourable contract.** From the perspective of a counterparty, a contract is unfavourable if its terms are less lucrative than current market terms. An unfavourable contract is not necessarily a contract that will result in a loss to the counterparty.

**Unrealized intercompany profit.** The excess of the transaction price over the carrying value of an item (usually inventory or long-lived assets) transferred from (or to) a parent to (or from) the subsidiary, or among subsidiaries, and not sold to an outside entity as of the end of the reporting period. For purposes of consolidated financial statements, recognition must be deferred until subsequent realization through a transaction with an unrelated party.

## BUSINESS COMBINATIONS AND CONSOLIDATIONS

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### IFRS 3(R) and IAS 27(R) and International Accounting Convergence

In January 2008, the IASB issued a revised version of IFRS 3, *Business Combinations*, which in this publication is being referred to as IFRS 3(R), as well as an amended version of IAS 27, *Separate Financial Statements*, which is being referred to as IAS 27(R). These standards were the product of the first major joint project undertaken by the IASB and the FASB. The consolidation section in IAS 27 is replaced by IFRS 10 (refer to Chapter 14).

Key changes introduced by IFRS 3(R) include:

- Option to measure non-controlling interest at fair value;
- Acquisition-related costs recognized in profit or loss as incurred;
- In step acquisitions, any previously held equity interest in the acquiree is remeasured at its acquisition-date fair value, with the resulting gains and losses recognized in profit or loss;
- Reassessing the classification or designation of all assets and liabilities acquired as required by other IFRS;
- Contingent consideration measured at fair value at the date of business combination, with subsequent changes (gains, losses) recognized in profit or loss;
- Reacquired rights recognized as intangible assets, separately from goodwill;
- Separate accounting for pre-existing relationships; and
- Indemnification assets measured on the same basis as the related liability.

Key changes introduced by IAS 27(R) are:

- Changes in a parent's controlling ownership interest that do not result in a loss of control are accounted for as equity transactions (transactions with owners in their capacity as owners). Consequently, no gain or loss, and no changes in the carrying values of the subsidiary's assets (including goodwill) or liabilities are recognized.
- Losses incurred by the subsidiary are allocated between controlling and non-controlling interests, even if losses attributed to the non-controlling interests exceed the non-controlling interests in the subsidiary's equity.
- On loss of control of a subsidiary, the parent derecognizes the individual assets, liabilities and equity related to that subsidiary (including any non-controlling interests and amounts previously recognized in other comprehensive income). Any retained interest in the former subsidiary should be valued at fair value at the date that control is lost; any resulting gain or loss is recognized in profit or loss.

IFRS 3(R) and IAS 27(R) should be applied prospectively, although early application was permitted. Therefore, any business combinations that were undertaken before the effective date of IFRS 3 (R) can be accounted for using the earlier version of the standard. As the existence of such business is not expected to be commonplace at this stage, the discussion that follows does not address the superseded IFRS 3 and IAS 27; readers needing such guidance should refer to *Wiley IFRS 2009*, which presented a full discussion of those earlier standards in addition to the current standards, IFRS 3(R) and IAS 27(R).

## Effective Date and Transition Provisions

IFRS 3(R) and IAS 27(R) came into effect for the first annual reporting period beginning on or after July 1, 2009. Early application was permitted, although the new pronouncements could not be applied to periods beginning prior to June 30, 2007. If an entity elected early adoption, it was necessary to adopt both IFRS 3(R) and IAS 27(R) at the same time.

Thus reporting entities must apply IFRS 3(R) prospectively to business combinations for which the acquisition date is on or after the beginning of the annual period in which the standard is adopted. Further, reporting entities are not permitted to retrospectively adjust the carrying amounts of assets and liabilities from previously recognized business combinations for the effects of the new pronouncements. Special transition provisions apply to mutual entities and with respect to amendments made to paragraph 68 of IAS 12, governing the accounting for current and deferred income taxes. After the date this IFRS is adopted, any change in a deferred tax benefit acquired in a business combination does not adjust goodwill, but is recognized in profit or loss for the period (or, if IAS 12 requires, outside profit or loss). These are discussed later in this chapter and in Chapter 26, Income Taxes.

## Objectives

IFRS 3(R) and IAS 27(R) follow a revised drafting convention, intended to be more principles-based than rules-based in approach. Thus, each major section of these pronouncements is preceded by a prominent statement of the main principles embodied by that section, presented in a boldfaced font for emphasis. All paragraphs and the appendices containing implementation guidance, whether boldfaced or not, are of equal authority, however.

The overriding objective of the new standards is to improve the relevance, representational faithfulness, transparency and comparability of information provided in financial statements about business combinations and their effects on the reporting entity by establishing principles and requirements with respect to how an acquirer, in its consolidated financial statements:

1. Recognizes and measures identifiable assets acquired, liabilities assumed, and the non-controlling interest in the acquiree, if any;
2. Recognizes and measures acquired goodwill or a gain from a bargain purchase;
3. Determines the nature and extent of disclosures sufficient to enable the reader to evaluate the nature of the business combination and its financial effects on the consolidated reporting entity;
4. Accounts for and reports non-controlling interests in subsidiaries; and
5. Deconsolidates a subsidiary when it ceases to hold a controlling interest in it.

## Scope

Transactions or other events that meet the definition of a business combination are subject to IFRS 3(R) and IAS 27(R). Excluded from the scope of these standards, however, are:

1. Formation of a joint venture;
2. Acquisition of an asset or group of assets that does not represent a business; and
3. Combinations between entities or businesses under common control.

Mutual entities (i.e., credit unions, cooperatives, etc.), those achieved by contract alone (providing control without ownership—i.e., dual-listed entities, stapled entity structures),

those achieved in stages (step acquisitions), those transferring less than 100% ownership, and bargain purchases are within the scope of the revised standards.

## **BUSINESS COMBINATIONS**

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The revised standard IFRS 3(R) replaces the cost principle of accounting for business combinations with the fair value principle. Under the cost (or cost allocation) principle, which was applied under IFRS 3, the exchange transaction was to be recorded at cost. That cost was to be allocated to the assets acquired and liabilities assumed; and goodwill was to be recognized for the difference between the cost and the fair value of the identifiable net assets acquired. In contrast, applying the fair value principle means that, upon obtaining control of the subsidiary, the exchange transaction is measured at fair value. All assets, liabilities, and equity (except equity acquired by the controlling interest) of the acquired entity are measured at fair value. However, several exceptions to this principle are provided in IFRS 3(R).

### **Determining Fair Values**

Accounting for acquisitions requires a determination of the fair value for each of the acquired entity's identifiable tangible and intangible assets and for each of its liabilities at the date of combination (except for assets which are to be resold and which are to be accounted for at fair value less costs to sell under IFRS 5; and for those items to which limited exceptions to recognition and measurement principles apply). IFRS 3(R) provides illustrative examples of how to treat certain assets, particularly intangibles, but provides no general guidance on determining fair value. The IASB recently issued IFRS 13, *Fair Value Measurement*, which defines the term *fair value*, and sets out in a single standard a framework for measuring fair value and the concomitant disclosures. The IFRS 13 standard is discussed in further detail within Chapter 25.

### **Transactions and Events Accounted for as Business Combinations**

A business combination results from the occurrence of a transaction or other event that results in an acquirer obtaining control of one or more businesses. This can occur in many different ways that include the following examples individually or in some cases, in combination:

1. Transfer of cash, cash equivalents or other assets, including the transfer of assets of another business of the acquirer;
2. Incurring liabilities;
3. Issuance of equity instruments;
4. Providing more than one type of consideration; or
5. By contract alone without the transfer of consideration, such as when:
  - a. An acquiree business repurchases enough of its own shares to cause one of its existing investors (the acquirer) to obtain control over it;
  - b. There is a lapse of minority veto rights that had previously prevented the acquirer from controlling an acquiree in which it held a majority voting interest; or
  - c. An acquirer and acquiree contractually agree to combine their businesses without a transfer of consideration between them.



### Qualifying as a Business

IFRS 3(R) substantively redefines the previous definition of a business which had been set forth for the first time in IFRS 3. This change may serve to increase the number of acquisition transactions that will be accounted for as business combinations, rather than purchases and assumptions of specific assets and liabilities, or as transactions that could be accounted for as book value combinations akin to the now-banned poolings of interests.

Under IFRS 3(R), in order to be considered a business, an integrated group of activities and assets must be *capable* of being conducted and managed to provide a return directly to investors, *owners, members or participants*. The return can be in the form of dividends, reduced costs, or other economic benefits. The word *capable* was added to emphasize the fact that the definition does not preclude a development stage enterprise from qualifying as a business. *Other owners, members or participants* were included to emphasize the applicability of IFRS 3(R) to mutual entities (e.g., credit unions and cooperatives) that previously used the pooling-of-interests method of accounting for business combinations and to non-corporate entities.

The definition and related guidance elaborate further that a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Clarification is provided that, while outputs are usually present in a business, they are not required to qualify as a business as long as there is the *ability* to create them.

An input is an economic resource that creates or has the ability to create outputs when one or more processes are applied to it. Examples of inputs include property, plant and equipment, intangible rights to use property, plant and equipment, intellectual property or other intangible assets, and access to markets in which to hire employees or purchase materials.

A process is a system, protocol, convention or rule with the ability to create outputs when applied to one or more inputs. Processes are usually documented; however, an organized workforce with the requisite skills and experience may apply processes necessary to create outputs by following established rules and conventions. In evaluating whether an activity is a process, IFRS 3(R) indicates that functions such as accounting, billing, payroll and other administrative systems do not meet the definition. Thus, processes are the types of activities that an entity engages in to produce the products and/or services that it provides to the marketplace rather than the internal activities it follows in operating its business.

An output is simply the by-product resulting from applying processes to inputs. An output provides, or has the ability to provide, a return to the investors, members, participants, or other owners.

In analysing a transaction or event to determine whether it is a business combination, it is not necessary that the acquirer retain, post-combination, all of the inputs or processes used by the seller in operating the business. If market participants could, for example, acquire the business in an arm's-length transaction and continue to produce outputs by integrating the business with their own inputs and processes, then that subset of remaining inputs and processes still meets the definition of a business from the standpoint of the acquirer.

The guidance in IFRS 3(R) provides additional flexibility by providing that it is not necessary that a business have liabilities, although that situation is expected to be rare. The broad scope of the term "capable of" requires judgement in determining whether an acquired set of activities and assets constitutes a business, to be accounted for applying the acquisition method.

As discussed previously, development stage enterprises are not precluded from meeting the criteria for being deemed a business. This is true even if they do not yet produce outputs. If there are no outputs being produced, the acquirer is to determine whether the enterprise constitutes a business by considering whether it:

1. Has started its planned principal activities;
2. Has hired employees;
3. Has obtained intellectual property;
4. Has obtained other inputs;
5. Has implemented processes that could be applied to its inputs;
6. Is pursuing a plan to produce outputs;
7. Will have the ability to obtain access to customers that will purchase the outputs.

It is important to note, however, that it is not required that all of these factors be present for a given set of development stage activities and assets to qualify as a business. Again, the relevant question to ask is whether a market participant would be capable of conducting or managing the set of activities and assets as a business irrespective of whether the seller did so or the acquirer intends to do so.

Finally, IFRS 3(R) provided what it acknowledged was the circular logic of asserting that, in the absence of evidence to the contrary, if goodwill is included in a set of assets and activities, it can be presumed to be a business. The circularity arises from the fact that, in order to apply IFRS to determine whether to initially recognize goodwill, the accountant would be required to first determine whether there had, in fact, been an acquisition of a business. Otherwise, it would not be permitted to recognize goodwill. It is not necessary, however, that goodwill be present in order to consider a set of assets and activities to be a business.

### **Techniques for Structuring Business Combinations**

A business combination can be structured in a number of different ways that satisfy the acquirer's strategic, operational, legal, tax and risk management objectives. Some of the more frequently used structures are:

1. One or more businesses become subsidiaries of the acquirer. As subsidiaries, they continue to operate as legal entities.
2. The net assets of one or more businesses are legally merged into the acquirer. In this case, the acquiree entity ceases to exist (in legal vernacular, this is referred to as a statutory merger and normally the transaction is subject to approval by a majority of the outstanding voting shares of the acquiree).
3. The owners of the acquiree transfer their equity interests to the acquirer entity or to the owners of the acquirer entity in exchange for equity interests in the acquirer.
4. All of the combining entities transfer their net assets or their owners transfer their equity interests into a new entity formed for the purpose of the transaction. This is sometimes referred to as a roll-up or put-together transaction.
5. A former owner or group of former owners of one of the combining entities obtains control of the combined entities collectively.
6. An acquirer might hold a non-controlling equity interest in an entity and subsequently purchase additional equity interests sufficient to give it control over the investee. These transactions are referred to as step acquisitions or business combinations achieved in stages.

## Accounting for Business Combinations under the Acquisition Method

The acquirer is to account for a business combination using the acquisition method. This term represents an expansion of the now-outdated term, “purchase method.” The change in terminology was made in order to emphasize that a business combination can occur even when a purchase transaction is not involved.

The following steps are required to apply the acquisition method:

1. Identify the acquirer;
2. Determine the acquisition date;
3. Identify the assets and liabilities, if any, requiring separate accounting because they result from transactions that are not part of the business combination, and account for them in accordance with their nature and the applicable IFRS;
4. Identify assets and liabilities that require acquisition date classification or designation decisions to facilitate application of IFRS in post-combination financial statements and make those classifications or designations based on:
  - a. Contractual terms;
  - b. Economic conditions;
  - c. Acquirer operating or accounting policies; and
  - d. Other pertinent conditions existing at the acquisition date;
5. Recognize and measure the identifiable tangible and intangible assets acquired and liabilities assumed;
6. Recognize and measure any non-controlling interest in the acquiree;
7. Measure the consideration transferred;
8. Recognize and measure goodwill or, if the business combination results in a bargain purchase, recognize a gain from the bargain purchase.

### *Step 1—Identify the acquirer*

IFRS 3(R), as did its predecessor standard, strongly emphasizes the concept that every business combination has an acquirer. In the “basis for conclusions” that accompanies IFRS 3(R), the IASB asserts that:

*. . . “true mergers” or “mergers of equals” in which none of the combining entities obtain control of the others are so rare as to be virtually non-existent . . .*<sup>1</sup>

The provisions of IFRS 10, *Consolidated Financial Statements*, should be used to identify the acquirer—the entity that obtains *control* of the acquiree. IFRS 3(R) carried forward the principle of IAS 22 that in a business combination accounted for using the acquisition method, the acquirer is the combining entity that obtains control of the other combining entities. According to the IASB, using the control concept for identifying the acquirer is consistent with using the control concept in IFRS 10.

While IFRS 10 provides that, in general, control is presumed to exist when the parent owns, directly or indirectly, a majority of the voting power of another entity, this is not an absolute rule to be applied in all cases. In fact, IFRS 10 explicitly provides that in exceptional circumstances, it can be clearly demonstrated that majority ownership does not constitute control, but rather that the minority ownership may constitute control (related IFRS

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<sup>1</sup> IFRS 3(R), paragraph BC35.

guidance is provided later in this chapter in the paragraph titled Presentation and Scope of Consolidated Financial Statements).

Exceptions to the general majority ownership rule include, but are not limited to the following situations:

1. An entity that is in legal reorganization or bankruptcy;
2. An entity subject to uncertainties due to government-imposed restrictions, such as foreign exchange restrictions or controls, whose severity casts doubt on the majority owner's ability to control the entity; or
3. If the acquiree is a special-purpose entity (SPE), the creator or sponsor of the SPE is always considered to be the acquirer. Accounting for SPEs is discussed later in this chapter.

If applying the guidance in IFRS 10 does not clearly indicate the party that is the acquirer, IFRS 3(R) provides factors to consider in making that determination under different facts and circumstances.

1. *Relative size*—Generally, the acquirer is the entity whose relative size is significantly larger than that of the other entity or entities. Size can be compared by using measures such as assets, revenues or net income.
2. *Initiator of the transaction*—When more than two entities are involved, another factor to consider (besides relative size) is which of the entities initiated the transaction.
3. *Roll-ups or put-together transactions*—When a new entity is formed to issue equity interests to effect a business combination, one of the pre-existing entities is to be identified as the acquirer. If, instead, a newly formed entity transfers cash or other assets, or incurs liabilities as consideration to effect a business combination, that new entity may be considered to be the acquirer.
4. *Non-equity consideration*—In business combinations accomplished primarily by the transfer of cash or other assets, or by incurring liabilities, the entity that transfers the cash or other assets, or incurs the liabilities is usually the acquirer.
5. *Exchange of equity interests*—In business combinations that are accomplished primarily by the exchange of equity interests, the entity that issues its equity interests is generally considered to be the acquirer. One notable exception that occurs frequently in practice is sometimes referred to as a reverse acquisition, discussed in detail later in this chapter. In a reverse acquisition, the entity issuing equity interests is legally the acquirer, but for accounting purposes is considered the acquiree. There are, however, other factors that should be considered in identifying the acquirer when equity interests are exchanged. These include:
  - a. *Relative voting rights in the combined entity after the business combination*—Generally, the acquirer is the entity whose owners, as a group, retain or obtain the largest portion of the voting rights in the consolidated entity. This determination must take into consideration the existence of any unusual or special voting arrangements as well as any options, warrants or convertible securities.
  - b. The existence of a large minority voting interest in the combined entity in the event no other owner or organized group of owners possesses a significant voting interest—Generally, the acquirer is the entity whose owner or organized group of owners holds the largest minority voting interest in the combined entity.

- c. *The composition of the governing body of the combined entity*—Generally, the acquirer is the entity whose owners have the ability to elect, appoint or remove a majority of members of the governing body of the combined entity.
- d. *The composition of the senior management of the combined entity*—Generally the acquirer is the entity whose former management dominates the management of the combined entity.
- e. *Terms of the equity exchange*—Generally, the acquirer is the entity that pays a premium over the pre-combination fair value of the equity interests of the other entity or entities.

### ***Step 2—Determine the acquisition date***

By definition, the acquisition date is that date on which the acquirer obtains control of the acquiree. As discussed previously, this concept of control is not always evidenced by ownership of voting rights.

The general rule is that the acquisition date is the date on which the acquirer legally transfers consideration, acquires the assets, and assumes the liabilities of the acquiree. This date, in a relatively straightforward transaction, is referred to as the closing date. Not all transactions are that straightforward, however. All pertinent facts and circumstances are to be considered in determining the acquisition date and this includes the meeting of any significant conditions precedent. The parties to a business combination might, for example, execute a contract that entitles the acquirer to the rights and obligates the acquirer with respect to the obligations of the acquiree prior to the actual closing date. Thus, in evaluating economic substance over legal form, the acquirer will have contractually acquired the target on the date it executed the contract.

#### **Example of acquisition date preceding closing date**

In 20XX, Henan Corporation (HC), a China-based holding company, purchased more than 20 wine brands and specified distribution assets from a French company. In its annual report, HC disclosed that the acquired assets were transferred to a subsidiary of the seller, in which HC received, in connection with the transaction, economic rights (these were structured as “tracker shares” in the holding subsidiary of the seller) with respect to the acquired assets prior to their actual legal transfer to the company. In addition, HC obtained the contractual right to manage the acquired assets prior to their legal transfer to HC, resulting in the acquirer obtaining control of the acquiree on the date before the closing date. Among the reasons HC cited for entering into these arrangements was their commercial desire to obtain the economic benefits associated with owning and operating the acquired assets as soon as possible after funding the purchase price for them.

Until the assets were legally transferred to HC, the transaction was accounted for under IFRS 10 and consequently, HC’s interests in the tracker shares of the seller’s subsidiary were consolidated since HC was considered the sponsor of that subsidiary. The seller’s residual interest in the holding subsidiary was reported in the consolidated financial statements of HC as a non-controlling interest.

### ***Step 3—Recognize and measure the identifiable tangible and intangible assets acquired and liabilities assumed***

In general, the measurement principle is that an acquirer measures the identifiable tangible and intangible assets acquired, and the liabilities assumed, at their fair values on the

acquisition date. IFRS 3(R) provides the acquirer with a choice of two methods to measure non-controlling interests arising in a business combination:

1. To measure the non-controlling interest at fair value (recognizing the acquired business at fair value); or
2. To measure the non-controlling interest at the non-controlling interest's share of the acquiree's net assets.

**Exceptions to the recognition and/or measurement principles.** IFRS 3(R) provides certain exceptions to its general principles for recognizing assets acquired and liabilities assumed at their acquisition date fair values. These can be summarized as follows:

<u>Nature of exception</u>	<u>Recognition</u>	<u>Measurement</u>
Contingent liabilities	X	
Income taxes	X	x
Employee benefits	X	x
Indemnification assets	X	x
Reacquired rights		x
Share-based payment awards		x
Assets held for sale		x

### Exceptions to the recognition principle

*Contingent liabilities of the acquiree.* In accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, a contingent liability is defined as:

1. A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
2. A present obligation that arises from past events but is not recognized because:
  - a. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - b. The amount of the obligation cannot be measured with sufficient reliability.

Under IFRS 3(R) the acquirer recognizes as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, regardless of the probability of cash flow arising (contrary to the principle that is established in IAS 37).

### Exceptions to both the recognition and measurement principles

*Income taxes.* The basic principle that applies to income tax accounting in a business combination (carried forward without change by IFRS 3(R)) is that the acquirer is to recognize in accordance with IAS 12, *Income Taxes*, as of the acquisition date, deferred income tax assets or liabilities for the future effects of temporary differences and carryforwards of the acquiree that either:

1. Exist on the acquisition date; or
2. Are generated by the acquisition itself.

However, IAS 12 has been amended in order to accommodate the new business combinations framework and, consequently, management must carefully assess the reasons

for changes in the deferred tax benefits during the measurement period. As a result of these amendments, deferred tax benefits that do not meet the recognition criteria at the date of acquisition are subsequently recognized as follows:

- Acquired deferred tax benefits recognized within the measurement period (within one year after the acquisition date) that result from new information regarding the facts and circumstances existing at the acquisition date, are accounted for as a reduction of goodwill related to this acquisition. If goodwill is reduced to zero, any remaining portion of the adjustment is recorded as a gain from a bargain purchase.
- All other acquired deferred tax benefits realized are recognized in profit or loss.

In addition, IAS 12 has been amended to require any tax benefits arising from the difference between the income tax basis and IFRS carrying amount of goodwill to be accounted for as any other temporary difference at the date of acquisition.

*Employee benefits.* Liabilities (and assets, if applicable), associated with acquiree employee benefit arrangements are to be recognized and measured in accordance with IAS 19, *Employee Benefits*. Any amendments to a plan (and their related income tax effects) that are made as a result of business combination are treated as a post-combination event and recognized in the acquirer's post-combination financial statements in the periods in which the changes occur.

*Indemnification assets.* Indemnification provisions are usually included in the voluminous closing documents necessary to effect a business combination. Indemnifications are contractual terms designed to fully or partially protect the acquirer from the potential adverse effects of an unfavourable future resolution of a contingency or uncertainty that exists at the acquisition date (e.g., legal or environmental liabilities, or uncertain tax positions). Frequently the indemnification is structured to protect the acquirer by limiting the maximum amount of post-combination loss that the acquirer would bear in the event of an adverse outcome. A contractual indemnification provision results in the acquirer obtaining, as a part of the acquisition, an indemnification asset and simultaneously assuming a contingent liability of the acquiree.

### **Exceptions to the measurement principle**

*Reacquired rights.* An acquirer and acquiree may have engaged in pre-acquisition business transactions such as leases, licenses, franchises, trade name or technology that resulted in the acquiree paying consideration to the acquirer to use tangible and/or intangible assets of the acquirer in the acquiree's business. The acquisition results in the acquirer reacquiring that right. The acquirer measures the value of a reacquired right recognized as an intangible asset. If the terms of the contract giving rise to a reacquired right are favourable or unfavourable compared with current terms and prices for the same or similar items, a settlement gain or loss will be recognized in profit or loss.

The IFRS accounting requirements after acquisition, on subsequently measuring and accounting for reacquired rights, contingent liabilities, and indemnification assets are discussed later in this chapter in the paragraph entitled "Post-combination measurement and accounting."

*Share-based payment awards.* In connection with a business combination, the acquirer often replaces the acquiree's share-based payment awards with share-based payment awards of the acquirer. Obviously, there are many valid business reasons for the exchange, not the

least of which is ensuring smooth transition and integration as well as retention of valued employees. The acquirer measures a liability or an equity instrument related to share-based payment transactions of the acquiree or the replacement of an acquiree's share-based payment awards with the acquirer's share-based awards in accordance with IFRS 2, *Share-Based Payment*, at the acquisition date.

*Assets held for sale.* Assets classified as held-for-sale individually or as part of a disposal group are to be measured at acquisition date fair value less cost to sell, consistent with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* (discussed in detail within Chapter 9). In determining fair value less cost to sell, it is important to differentiate costs to sell from expected future losses associated with the operation of the long-lived asset or disposal group to which it belongs.

In post-acquisition periods, long-lived assets classified as held-for-sale are not to be depreciated or amortized. If the assets are part of a disposal group (discussed within Chapter 9), interest and other expenses related to the liabilities included in the disposal group continue to be accrued.

Costs to sell are defined as the incremental direct costs necessary to transact a sale. To qualify as costs to sell, the costs must result directly from the sale transaction, incurring them needs to be considered essential to the transaction, and the cost would not have been incurred by the entity in the absence of a decision to sell the assets. Examples of costs to sell include brokerage commissions, legal fees, title transfer fees and closing costs necessary to effect the transfer of legal title. Costs to sell are expressly not permitted to include any future losses that are expected to result from operating the assets (or disposal group) while it is classified as held-for-sale. If the expected timing of the sale exceeds one year from the end of the reporting period, which is permitted in limited situations by paragraph B1 of IFRS 5, the costs to sell are to be discounted to their present value.

Should a loss be recognized in subsequent periods due to a decline in the fair value less cost to sell, such losses may be restored by future periods' gains only to the extent to which the losses have been recognized cumulatively from the date the asset (or disposal group) was classified as held-for-sale.

IFRS guidance on recognizing and measuring the identifiable assets acquired and liabilities assumed is discussed later in this chapter in the paragraph entitled "Additional guidance in applying the acquisition method."

#### ***Step 4—Identify assets and liabilities requiring separate accounting***

IFRS 3(R) provides a basic recognition principle that, as of the acquisition date, the acquirer is to recognize, separately from goodwill, the fair values of all identifiable assets acquired (whether tangible or intangible), the liabilities assumed, and, if applicable, any non-controlling interest (previously referred to as "minority interest") in the acquiree.

In applying the recognition principle to a business combination, the acquirer may recognize assets and liabilities that had not been recognized by the acquiree in its pre-combination financial statements but which meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* at the acquisition date. IFRS 3(R) continues to permit recognition of acquired intangibles (e.g., patents, customer lists) that would not be granted recognition if they were internally developed.

The pronouncement elaborates on the basic principle by providing that recognition is subject to the following conditions:



1. At the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities as set forth in the *Conceptual Framework for Financial Reporting*;<sup>2</sup> and
2. The assets and liabilities recognized must be part of the exchange transaction between the acquirer and the acquiree (or the acquiree's former owners) and not part of a separate transaction or transactions.

**Restructuring or exit activities.** Frequently, in a business combination, the acquirer's plans include the future exit of one or more of the activities of the acquiree or the termination or relocation of employees of the acquiree. Since these exit activities are discretionary on the part of the acquirer and the acquirer is not obligated to incur the associated costs, the costs do not meet the definition of a liability and are not recognized at the acquisition date. Rather, the costs will be recognized in post-combination financial statements in accordance with other IFRS.

**Boundaries of the exchange transaction.** Pre-existing relationships and arrangements often exist between the acquirer and acquiree prior to beginning negotiations to enter into a business combination. Furthermore, while conducting the negotiations, the parties may enter into separate business arrangements. In either case, the acquirer is responsible for identifying amounts that are not part of the exchange for the acquiree. Recognition under the acquisition method is only given to the consideration transferred for the acquiree and the assets acquired and liabilities assumed in exchange for that consideration. Other transactions outside the scope of the business combination are to be recognized by applying other relevant IFRS.

The acquirer is to analyse the business combination transaction and other transactions with the acquiree and its former owners to identify the components that comprise the transaction in which the acquirer obtained control over the acquiree. This distinction is important to ensure that each component is accounted for according to its economic substance, irrespective of its legal form.

The imposition of this condition was based on an observation that, upon becoming involved in negotiations for a business combination, the parties may exhibit characteristics of related parties. In so doing, they may be willing to execute agreements designed *primarily* for the benefit of the acquirer of the combined entity that might be designed to achieve a desired financial reporting outcome after the business combination has been consummated. Thus, the imposition of this condition is expected to curb such abuses.

In analysing a transaction to determine inclusion or exclusion from a business combination, consideration should be given to which of the parties will reap its benefits. If a pre-combination transaction is entered into by the acquirer, or on behalf of the acquirer, or *primarily* to benefit the acquirer (or to benefit the to-be-combined entity as a whole) rather than for the benefit of the acquiree or its former owners, the transaction most likely would be considered to be a "separate transaction" outside the boundaries of the business combination and for which the acquisition method would not apply.

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<sup>2</sup> *Assets are defined as "present economic resources: (1) controlled by an entity, through an enforceable right or other means, as a result of past events; and (2) from which future economic benefits are expected to flow to the entity" (IAS 38, Framework). Liabilities are defined as "present unconditional economic obligations, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits" (IAS 37, Framework).*

The acquirer is to consider the following factors, which the IASB states “are neither mutually exclusive nor individually conclusive,” in determining whether a transaction is a part of the exchange transaction or recognized separately:

1. *Purpose of the transaction*—Typically, there are many parties involved in the management, ownership, operation and financing of the various entities involved in a business combination transaction. Of course, there are the acquirer and acquiree entities, but there are also owners, directors, management and various parties acting as agents representing their respective interests. Understanding the motivations of the parties in entering into a particular transaction potentially provides insight into whether or not the transaction is a part of the business combination or a separate transaction.
2. *Initiator of the transaction*—Identifying the party that initiated the transaction may provide insight into whether or not it should be recognized separately from the business combination. IASB believes that if the transaction was initiated by the acquirer, it would be less likely to be part of the business combination and, conversely, if it were initiated by the acquiree or its former owners, it would be more likely to be part of the business combination.
3. *Timing of the transaction*—Examining the timing of the transaction may provide insight into whether, for example, the transaction was executed in contemplation of the future business combination in order to provide benefits to the acquirer or the post-combination entity. IASB believes that transactions that take place during the negotiation of the terms of a business combination may be entered into in contemplation of the eventual combination for the purpose of providing future economic benefits *primarily* to the acquirer of the to-be-combined entity and, therefore, should be accounted for separately.

IFRS 3(R) provides the following pair of presumptions after analysing the economic benefits of a pre-combination transaction:

<u>Primarily for the benefit of</u>	<u>Transaction likely to be</u>
Acquirer or combined entity	Separate transaction
Acquiree or its former owners	Part of the business combination

IFRS 3(R) provides three examples of separate transactions that are *not* to be included in applying the acquisition method:

1. A settlement of a pre-existing relationship between acquirer and acquiree;
2. Compensation to employees or former owners of the acquiree for future services; and
3. Reimbursement to the acquiree or its former owners for paying the acquirer’s acquisition-related costs.

The paragraph entitled, “Determining what is part of the business combination transaction,” later in this chapter, will discuss related application guidance for these transactions that are separate from the business combination (i.e., not part of the exchange for the acquiree).

In a departure from the original version of IFRS 3, acquisition-related costs are, under IFRS 3(R), generally expensed through profit or loss at the time the services are received, which will generally be prior to, or at, the date of the acquisition. This is consistent with the now-prevalent view that such costs do not increase the *value* of the assets acquired, and thus should not be capitalized.

**Step 5—Classify or designate identifiable assets acquired and liabilities assumed**

In order to facilitate the combined entity's future application of IFRS in its post-combination financial statements, management is required to make decisions on the acquisition date relative to the classification or designation of certain items. These decisions are to be based on the contractual terms, economic and other conditions, and the acquirer's operating and accounting policies as they exist *on the acquisition date*. Examples include, but are not limited to, the following:

1. Classification of investments in certain debt and equity securities as trading, available-for-sale, or held-to-maturity under IAS 39, *Financial Instruments: Recognition and Measurement* (or IFRS 9 if adopted);
2. Designation of a derivative instrument as a hedging instrument under the provisions of IAS 39 (or IFRS 9 if adopted).

In applying Step 5, specific exceptions are provided for lease contracts and insurance contracts: classification of a lease contract as either an operating lease or a finance lease in accordance with IAS 17, *Leases*, and classification of a contract as an insurance contract in accordance with IFRS 4, *Insurance Contracts*. Generally, these contracts are to be classified by reference to the contractual terms and other factors that were applicable *at their inception* rather than at the acquisition date. If, however, the contracts were modified subsequent to their inception and those modifications would change their classification at that date, then the accounting for the contracts will be determined by the modification date facts and circumstances. Under these circumstances, the modification date could be the same as the acquisition date.

**Step 6—Recognize and measure any non-controlling interest in the acquiree**

The term “non-controlling interest” replaces the term “minority interest” in referring to that portion of the acquiree, if any, not controlled by the parent subsequent to the acquisition. The term “minority interest” became an inadequate descriptor because under IAS 27(R) and SIC 12, *Consolidation—Special-Purpose Entities*, an entity can possess a controlling financial interest in another entity without possessing a majority of the voting interests of that entity. Thus it would be inaccurate, in many cases, to refer to the party that does not possess a controlling financial interest as a “minority” since that party could, in fact, hold a majority of the voting equity of the acquiree.

IFRS 3(R) provides the acquirer with a choice of two methods to measure non-controlling interests at the acquisition date arising in a business combination:

1. To measure the non-controlling interest at *fair value* (also recognizing the acquired business at fair value); or
2. To measure the non-controlling interest at the present ownership instruments' share in the recognized amounts of the acquiree's identifiable net assets (under this approach the only difference is that, in contrast to the approach of measuring the non-controlling interest at fair value, no portion of imputed goodwill is allocated to the non-controlling interest). Before the May 2010 improvement this option referred to non-controlling interest's proportionate share of the acquiree's identifiable net assets.

In terms of the May 2010 improvement, this choice is only available for present ownership interest that entitles the holder to a proportionate share of the entity's net assets

in the event of liquidation. All other components of non-controlling interest are measured at the acquisition date fair value unless required otherwise by IFRS.

The choice of the method to measure the non-controlling interest should be made separately for each business combination rather than as an accounting policy. In making this election, management must carefully consider all factors, since the two methods may result in significantly different amounts of goodwill recognized, as well as different accounting for any changes in the ownership interest in a subsidiary. One important factor would be the entity's future intent to acquire non-controlling interest, because of the potential effects on equity when the outstanding non-controlling interest is acquired. Contrary to the previous practice under the original IFRS 3, the subsequent acquisition of the outstanding non-controlling interest under IFRS 3(R) would not result in additional goodwill being recognized, since such a transaction would be considered as taking place between shareholders.

**Measuring non-controlling interest at fair value.** IFRS 3(R) allows the non-controlling interest in the acquiree to be measured at fair value at the acquisition date, determined based on market prices for equity shares not held by the acquirer, or, if not available, by using a valuation technique. If the acquirer is not acquiring all of the shares in the acquiree and there is an active market for the remaining outstanding shares in the acquiree, the acquirer may be able to use the market price to measure the fair value of the non-controlling interest. Otherwise, the acquirer would measure fair value using other valuation techniques. Under this approach, recognized goodwill represents all of the goodwill of the acquired business, not just the acquirer's share, as recognized under original IFRS 3.

In applying the appropriate valuation technique to determine the fair value of the non-controlling interest, it is likely that there will be a difference in the fair value per share of the non-controlling interest and the fair value per share of the controlling interest (the acquirer's interest in the acquiree). This difference is likely to be the inclusion of a control premium in the per-share fair value of the controlling interest or, similarly, what has been referred to as a "non-controlling interest discount" applicable to the non-controlling shares. Obviously, an investor would be unwilling to pay the same amount per share for equity shares in an entity that did not convey control of that entity as it would pay for shares that did convey control. For this reason the amount of consideration transferred by an acquirer is not usually indicative of the fair value of the non-controlling interest, since the consideration transferred by the acquirer often includes a control premium.

#### Example of measuring non-controlling interest at fair value

Konin Corporation (KC) acquires a 75% interest in Bartovia Corporation (BC), in exchange for cash of €360,000. BC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding, at €6 per share. The fair value of BC's identifiable net assets is €300,000; the shares of BC at the acquisition date are traded at €5 per share.

Under the full fair value approach, the non-controlling interest is measured based on the trading price of the shares of entity BC at the date control is obtained by KC (€5 per share) and a value of €100,000 is assigned to the 25% non-controlling interest, indicating that KC has paid a control premium of €60,000 (€360,000 – [€5 × 60,000])

$$\text{Equity} - \text{Non-controlling interest in net assets} (\text{€}5 \times 20,000) = \text{€}100,000$$

It is important to note from this analysis that, from the perspective of the acquirer, the computation of the acquisition-date fair value of the non-controlling interest in the acquiree is not computed by simply multiplying the same fair value per share that the acquirer paid for its

controlling interest. Such a calculation would have yielded a different result.

$$\text{Equity} - \text{Non-controlling interest in net assets} (\text{€}6 \times 20,000) = \text{€}120,000$$

If this method had been used, the non-controlling interest would be overvalued by €20,000 (the difference between €120,000 and €100,000).

Under the fair value approach to measure non-controlling interest, the acquired business will be recognized at fair value, with the controlling share of total goodwill assigned to the controlling interest and the non-controlling share allocated to the non-controlling interest.

**Measuring non-controlling interest at its share of the identifiable net assets of the acquiree, calculated in accordance with IFRS 3(R).** Under this approach, non-controlling interest is measured as the non-controlling interest's proportionate interest in the value of the identifiable assets and liabilities of the acquiree, determined under current requirements of IFRS 3(R).

**Example of measuring non-controlling interest at share of net assets of the acquiree**

Konin Corporation (KC) acquires a 75% interest in Bartovia Corporation (BC), in exchange for cash of €360,000. BC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding, at €6 per share. The fair value of BC's identifiable net assets is €300,000; the shares of entity BC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €60,000 (€360,000 – [€5 × 60,000])

Since KC elects to measure non-controlling interest in BC at its share of the acquiree's net assets, a value of €75,000 is assigned to the 25% non-controlling interest.

$$\text{Equity} - \text{Non-controlling interest in net assets} (\text{€}300,000 \times 25\%) = \text{€}75,000$$

Under this approach to measure non-controlling interest, goodwill recognized will represent only the acquirer's share, as was the practice prior to the effective date of IFRS 3(R).

IAS 27(R) settles the long-controversial issue of how the non-controlling interest is to be classified in the consolidated statement of financial position by requiring that it be reported within the equity section, separately from the equity of the parent company, and clearly identified with a caption such as “non-controlling interest in subsidiaries.” Should there be non-controlling interests attributable to more than one consolidated subsidiary, the amounts may be aggregated in the consolidated statement of financial position.

Only equity-classified instruments issued by the subsidiary may be classified as equity in this manner. If, for example, the subsidiary had issued a financial instrument that, under applicable IFRS, was classified as a liability in the subsidiary's financial statements, that instrument would not be classified as a non-controlling interest since it does not represent an ownership interest.

**Step 7—Measure the consideration transferred**

In general, consideration transferred by the acquiree is measured at its acquisition-date fair value. Examples of consideration that could be transferred include cash, other assets, a business, a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants and member interests of mutual entities. The aggregate consideration transferred is the sum of the following elements measured at the acquisition date:

1. The fair value of the assets transferred by the acquirer;

2. The fair value of the liabilities incurred by the acquirer to the former owners of the acquiree; and
3. The fair value of the equity interests issued by the acquirer subject to the measurement exceptions discussed earlier in this chapter for the portion, if applicable, of acquirer share-based payment awards exchanged for awards held by employees of the acquiree that is included in consideration transferred.

To the extent the acquirer transfers consideration in the form of assets or liabilities with carrying amounts that differ from their fair values at the acquisition date, the acquirer is to remeasure them at fair value and recognize a gain or loss on the acquisition date. If, however, the transferred assets or liabilities remain within the consolidated entity post-combination, with the acquirer retaining control of them, no gain or loss is recognized, and the assets or liabilities are measured at their carrying amounts to the acquirer immediately prior to the acquisition date. This situation can occur, for example, when the acquirer transfers assets or liabilities to the entity being acquired rather than to its former owners.

The structure of the transaction may involve the exchange of equity interests between the acquirer and either the acquiree or the acquiree's former owners. If the acquisition-date fair value of the acquiree's equity interests is more reliably measurable than the equity interests of the acquirer, the fair value of the acquiree's equity interests is to be used to measure the consideration transferred.

When a business combination is effected without transferring consideration—for example, by contract alone—the acquisition method of accounting also applies. Examples of such combinations include:

- The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control;
- Minority veto rights lapse that kept the acquirer, holding the majority voting rights, from controlling an acquiree;
- The acquirer and acquiree agree to combine their businesses by contract alone (e.g., a stapling arrangement or dual-listed corporation).

In a business combination achieved by contract alone, the entities involved are not under common control and the combination does not involve one of the combining entities obtaining an ownership interest in another combining entity. Consequently, there is a 100% non-controlling interest in the acquiree's net assets since the acquirer must contribute the fair value of the acquiree's assets and liabilities to the owners of the acquiree. Depending on the option elected to measure non-controlling interest (at fair value or share of the acquiree's net assets), this may result in recognizing goodwill allocated only to the non-controlling interest or recognizing no goodwill at all.

**Contingent consideration.** In many business combinations, the acquisition price is not completely fixed at the time of the exchange, but is instead dependent on the outcome of future events. There are two major types of contingent future events that might commonly be used to modify the acquisition price: the performance of the acquired entity (acquiree), and the market value of the consideration initially given for the acquisition.

The most frequently encountered contingency involves the post-acquisition performance of the acquired entity or operations. The contractual agreement dealing with this is often referred to as an “earn out” provision. It typically calls for additional payments to be made to

the former owners of the acquiree if defined revenue or earnings thresholds are met or exceeded. These may extend for several years after the acquisition date, and may define varying thresholds for different years. For example, if the acquiree during its final pre-transaction year generated revenues of €4 million, there might be additional sums due if the acquired operations produced €4.5 million or greater revenues in year one after the acquisition, €5 million or greater in year two and €6 million in year three.

Contingent consideration arrangements in connection with business combinations can be structured in many different ways and can result in the recognition of either assets or liabilities under IFRS 3(R). An acquirer may agree to transfer (or receive) cash, additional equity instruments, or other assets to (or from) former owners of an acquiree after the acquisition date, if certain specified events occur in the future. In either case, according to IFRS 3(R) the acquirer is to include contingent assets and liabilities as part of the consideration transferred, measured at acquisition-date fair value, which represents a significant change from past practice under original standard IFRS 3. In accordance with IFRS 3(R), contingent consideration can only be recognized when the contingency is probable and can be reliably measured.

If the contingent consideration includes a future payment obligation, that obligation is to be classified as either a liability or equity under the provisions of:

- Paragraph 11 of IAS 32, *Financial Instruments: Presentation*; or
- Other applicable IFRS.

The acquirer is to carefully consider information obtained subsequent to the acquisition-date measurement of contingent consideration. Additional information obtained during the measurement period that relates to the facts and circumstances that existed at the acquisition date result in measurement period adjustments to the recognized amount of contingent consideration and a corresponding adjustment to goodwill or gain from bargain purchase. The IFRS accounting requirements on subsequently measuring and accounting for contingent consideration in the post-combination periods is discussed later in this chapter in the paragraph entitled, “Post-combination measurement and accounting.”

### ***Step 8—Recognize and measure goodwill or gain from a bargain purchase***

The last step in applying the acquisition method is the measurement of goodwill or a gain from a bargain purchase. Goodwill represents an intangible that is not specifically identifiable. It results from situations when the amount the acquirer is willing to pay to obtain its controlling interest exceeds the aggregate recognized values of the net assets acquired, measured following the principles of IFRS 3(R). It arises largely from the synergies and economies of scale expected from combining the operations of the acquirer and acquiree. Goodwill’s elusive nature as an unidentifiable, residual asset means that it cannot be measured directly but rather can only be measured by reference to the other amounts measured as a part of the business combination. In accordance with IFRS 3(R) management must select, for each acquisition, the option to measure the non-controlling interest, and consequently the amount recognized as goodwill (or gain on a bargain purchase) will depend on whether non-controlling interest is measured at fair value (option 1), or at the non-controlling interest’s share of the acquiree’s net assets (option 2).

GW	=	Goodwill
GBP	=	Gain from a bargain purchase

NI	=	Non-controlling interest in the acquiree, if any, measured at fair value (option 1); or as the non-controlling interest's share of the acquiree's net assets (option 2)
CT	=	Consideration transferred, generally measured at acquisition-date fair value
PE	=	Fair value of the acquirer's previously held interest in the acquiree if the acquisition was achieved in stages
NA	=	Net assets acquired—consisting of the acquisition-date fair values (or other amounts recognized under the requirements of IFRS 3[R] as described in the chapter) of the identifiable assets acquired and liabilities assumed.
GW(or GBP)	=	$(CT + NI + PE) - NA$

Thus, when application of the formula yields an excess of the acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest and plus fair value of the acquirer's previously held equity interest over the net assets acquired, this means that the acquirer has paid a premium for the acquisition and that premium is characterized as goodwill.

When the opposite is true, that is, when the formula yields a negative result, a gain from a bargain purchase (sometimes referred to as negative goodwill) is recognized, since the acquirer has, in fact, obtained a bargain purchase as the value the acquirer obtained in the exchange exceeded the fair value of what it surrendered.

In a business combination in which no consideration is transferred, the acquirer is to use one or more valuation techniques to measure the acquisition-date fair value of its equity interest in the acquiree and substitute that measurement in the formula for "CT," the consideration transferred. The techniques selected require the availability of sufficient data to properly apply them and are to be appropriate for the circumstances. If more than one technique is used, management of the acquirer is to evaluate the results of applying the techniques including the extent of data available and how relevant and reliable the inputs (assumptions) used are. Guidance on the use of valuation techniques is provided in the standard, IFRS 13, *Fair Value Measurement*, presented in Chapter 25.

**Example of recognizing goodwill—non-controlling interest measured at the non-controlling interest's proportionate share of the acquiree's net assets**

Konin Corporation (KC) acquires a 75% interest in Donna Corporation (DC), in exchange for cash of €350,000. DC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding. The fair value of DC's identifiable net assets is €300,000; the shares of DC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €50,000 ( $€350,000 - [€5 \times 60,000]$ )

Management elects the option to measure non-controlling interest at its share of the acquiree's net assets and a value assigned to the non-controlling interest is €75,000 ( $€300,000 \times 25\%$ ).

The amount of goodwill recognized is only €125,000 which is equal to the consideration transferred €350,000 for the controlling interest minus the controlling interest's share in the fair value of the identifiable net assets acquired €225,000 ( $€300,000 \times 75\%$ ). No goodwill is assigned to the non-controlling interest. The acquirer (KC) would record its acquisition of DC in its consolidated financial statement as follows:



Identifiable net assets acquired, at fair value	300,000	
Goodwill (€425,000–300,000)	125,000	
Equity—Non-controlling interest		75,000
Cash		350,000

Under the approach to measure non-controlling interest at the proportionate share of the acquiree's net assets, goodwill recognized €125,000 (€350,000 + €75,000 – €300,000) represents only the acquirer's share of the goodwill.

**Example of recognizing goodwill—non-controlling interest measured at fair value**

Konin Corporation (KC) acquires a 75% interest in Danube Corporation (DC), in exchange for cash of €350,000. DC has 25% of its shares traded on an exchange; KC acquired the 60,000 non-publicly traded shares outstanding. The fair value of DC's identifiable net assets is €300,000; the shares of DC at the acquisition date are traded at €5 per share. The consideration transferred indicates that KC has paid a control premium of €50,000 (€350,000 – [€5 × 60,000])

Management elects the option to measure non-controlling interest at fair value and a value of €100,000 is assigned to the 25% non-controlling interest. The amount of goodwill accruing to the controlling interest is €125,000, which is equal to the consideration transferred, €350,000, for the controlling interest minus the controlling interest's share in the fair value of the identifiable net assets acquired, €225,000 (€300,000 × 75%). The amount of goodwill accruing to the non-controlling interest is €25,000 (€150,000 total goodwill less €125,000 allocated to the controlling interest). The acquirer (KC) would record its acquisition of DC in its consolidated financial statements as follows:

Identifiable net assets acquired, at fair value	300,000	
Goodwill (€450,000 – €300,000)	150,000	
Equity—Non-controlling interest		75,000
Cash		350,000

Under the approach to measure non-controlling interest at fair value, the acquired business is recognized at €450,000 (€350,000 + 100,000) fair value and full goodwill (€150,000 = €450,000 – €300,000) is recognized. The amount of goodwill associated with the controlling interest is €125,000 (€350,000 – (€300 000 × 75%)), and the amount of goodwill associated with non-controlling interest is €25,000 (€150,000 – €125 000).

**Bargain purchases.** A bargain purchase occurs when the value of net assets acquired is in excess of the acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest and plus fair value of the acquirer's previously held equity interest. While not common, this can happen, as for example in a business combination that is a forced sale, when the seller is acting under compulsion.

Under IFRS 3(R), when a bargain purchase occurs, a gain on acquisition is recognized in profit or loss at the acquisition date, as part of income from continuing operations.

Before recognizing a gain on a bargain purchase, IASB prescribed a verification protocol for management to follow given the complexity of the computation involved. If the computation initially yields a bargain purchase, management of the acquirer is to perform the following procedures before recognizing a gain on the bargain purchase:

1. Perform a completeness review of the identifiable tangible and intangible assets acquired and liabilities assumed to reassess whether all such items have been correctly identified. If any omissions are found, recognize the assets and liabilities that had been omitted.

2. Perform a review of the procedures used to measure all of the following items. The objective of the review is to ensure that the acquisition-date measurements appropriately considered all available information available at the acquisition date relating to:
  - a. Identifiable assets acquired;
  - b. Liabilities assumed;
  - c. Consideration transferred;
  - d. Non-controlling interest in the acquiree, if applicable; and
  - e. Acquirer's previously held equity interest in the acquiree for a business combination achieved in stages.

#### Example of a bargain purchase

On January 1, 20XX, Konin Corporation (KC) acquires 75% of the equity interests of Laska Corporation (LC), a private entity, in exchange for cash of €250,000. The former owners of LC were forced to sell their investments within a short period of time and unable to market LC to multiple potential buyers in the marketplace. The management of KC initially measures at the acquisition date in accordance with IFRS 3(R) the separately recognizable identifiable assets acquired at €500,000 and liabilities at €100,000. KC engages an independent valuation specialist who determines that the fair value of the 25% non-controlling interest in LC is €110,000.

Since the amount of KC identifiable net assets (€400,000 calculated as €500,000 – €100,000) exceeds the fair value of the consideration transferred (€250,000) plus the fair value of the non-controlling interest (€110,000), the acquisition initially results in a bargain purchase. In accordance with the requirements of IFRS 3(R), KC must perform a review to ensure whether all assets, liabilities, consideration transferred, and non-controlling interest have been correctly measured. KC concludes that the procedures and resulting measures are correct.

The acquirer (KC) recognizes the gain on its acquisition of the 75% interest as follows:

Identifiable net assets acquired, at fair value		400,000
Less: Fair value of the consideration transferred for 75% interest in LC	250,000	
Plus: Fair value of non-controlling interest in LC	110,000	360,000
Gain on bargain purchase		40,000

The acquirer (KC) would record its acquisition of LC in its consolidated financial statements as follows:

Identifiable net assets acquired	400,000	
Cash		250,000
Gain on the bargain purchase		40,000
Equity—Non-controlling interest in LC		110,000

If the acquirer (KC) elects to measure the non-controlling interest in LC on the basis of its proportionate interest in the identifiable net assets of the acquiree, the recognized amount of the non-controlling interest would be €100,000 (€400,000 × 25%); the gain on the bargain purchase would be €50,000 (€400,000 – [€250,000 + €100,000]).

**Measurement period.** More frequently than not, management of the acquirer does not obtain all of the relevant information needed to complete the acquisition-date measurements in time for the issuance of the first set of interim or annual financial statements subsequent to the business combination. If the initial accounting for the business combination has not been

completed by that time, the acquirer is to report provisional amounts in the consolidated financial statements for any items for which the accounting is incomplete. IFRS 3(R) provides for a “measurement period” during which any adjustments to the provisional amounts recognized at the acquisition date are to be retrospectively adjusted to reflect new information that management obtains regarding facts and circumstances existing as of the acquisition date. Information that has a bearing on this determination must not relate to post-acquisition events or circumstances. The information is to be analysed to determine whether, if it had been known at the acquisition date, it would have affected the measurement of the amounts recognized as of that date.

In evaluating whether new information obtained is suitable for the purpose of adjusting provisional amounts, management of the acquirer is to consider all relevant factors. Critical in this evaluation is the determination of whether the information relates to facts and circumstances as they existed at the acquisition date, or the information results from events occurring after the acquisition date. Relevant factors include:

1. The timing of the receipt of the additional information; *and*
2. Whether management of the acquirer can identify a reason that a change is warranted to the provisional amounts.

Obviously, information received shortly after the acquisition date has a higher likelihood of relevance to acquisition-date circumstances than information received months later. However, the measurement period should not exceed one year from the acquisition date.

#### Example of consideration of new information obtained during the measurement period

Konin Corporation (KC) acquired Automotive Industries, Inc. (AI) on September 30, 20XX-1. KC hired independent valuation specialists to determine valuation for an asset group acquired in the combination, but the valuation was not complete by the time KC authorized for issue its 20XX-1 consolidated financial statements. As a result, KC assigned a provisional fair value of €40 million to an asset group acquired, consisting of a factory and related machinery that manufactures engines used in large trucks and sport utility vehicles (SUVs).

As of the acquisition date, the average cost of gasoline in the markets served by the customers of AI was €4.30 per gallon. For the first six months subsequent to the acquisition, the per-gallon price of gasoline was relatively stable and only fluctuated slightly up or down on any given day. Upon further analysis, management was able to determine that, during that six-month period, the production levels of the asset group and related order backlog did not vary substantially from the acquisition date.

In April 20XX, however, due to an accident on April 3, 20XX, at a large refinery, the average cost per gallon skyrocketed to more than €6.00. As a result of this huge spike in the price of fuel, AI's largest customers either cancelled orders or sharply curtailed the number of engines they had previously ordered.

**Scenario 1:** On March 31, 20XX, management of KC received the independent valuation, which estimated the assets' acquisition-date fair value as €30 million. Given the fact that management was unable to identify any changes that occurred during the measurement period that would have accounted for a change in the acquisition-date fair value of the asset group, management determines that it will retrospectively reduce the provisional fair value assigned to the asset group to €30 million.

In its financial statements for the year ended December 31, 20XX, KC retrospectively adjusted the 20XX-1 prior year information as follows:

1. The carrying amount of assets is decreased by €10,600. That adjustment is measured as the fair value adjustment at the acquisition date of €10,000 plus the reduced depreciation that would

have been recognized if the asset's fair value at the acquisition date had been recognized from that date (€600 for three months' depreciation).

2. The carrying amount of goodwill as of December 31, 20XX-1 is increased by €10,000.
3. Depreciation expense for 20XX-1 is decreased by €600.

**Scenario 2:** KC has not received the independent valuation of assets until May 20XX. On April 15, 20XX, management of KC signed a sales agreement with Jonan International (JI) to sell the asset group for €30 million. Given the intervening events that affected the price of fuel and the demand for AI's products, management determines that the €10 million decline in the fair value of the asset group from the provisional fair value it was originally assigned resulted from those intervening changes and, consequently does not adjust the provisional fair value assigned to the asset group at the acquisition date.

In addition to adjustments to provisional amounts recognized, the acquirer may determine during the measurement period that it omitted recognition of additional assets or liabilities that existed at the acquisition date. During the measurement period, any such assets or liabilities identified are also to be recognized and measured on a retrospective basis.

In determining adjustments to the provisional amounts assigned to assets and liabilities, management should be alert for interrelationships between recognized assets and liabilities. For example, new information that management obtains that results in an adjustment to the provisional amount assigned to a liability for which the acquiree carries insurance could also result in an adjustment, in whole or in part, to a provisional amount recognized as an asset representing the claim receivable from the insurance carrier. In addition, as discussed in this chapter and Chapter 26, changes in provisional amounts assigned to assets and liabilities frequently will also affect temporary differences between the items' income tax basis and IFRS carrying amount, which in turn will affect the computation of deferred income assets and liabilities.

Adjustments to the provisional amounts that are made during the measurement period are recognized retrospectively as if the accounting for the business combination had actually been completed as of the acquisition date. This will result in the revision of comparative information included in the financial statements for prior periods including any necessary adjustments to depreciation, amortization, or other effects on profit or loss or other comprehensive income related to the adjustments. The measurement period ends on the *earlier* of:

1. The date management of the acquirer receives the information it seeks regarding facts and circumstances as they existed at the acquisition date or learns that it will be unable to obtain any additional information; *or*
2. One year after the acquisition date.

After the end of the measurement period, the only revisions that are permitted to be made to the initial acquisition-date accounting for the business combination are restatements for corrections of prior period errors in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, discussed in detail within Chapter 7.

### ***Acquisition-related costs***

In a departure from general practice and the requirements of original standard IFRS 3, acquisition-related costs, under IFRS 3(R), are generally to be charged to expense of the

period in which the costs are incurred and the related services received. Examples of these costs include:

Accounting fees	Internal acquisitions department costs
Advisory fees	Legal fees
Consulting fees	Other professional fees
Finder's fees	Valuation fees

Under the previous IFRS 3, such costs were to be included in the cost of the business combination and accordingly also included in the calculation of goodwill. In accordance with the revised standard, IFRS 3(R), because such costs are not part of the fair value exchange between the buyer and the seller for the acquired business, they are accounted for separately, as operating costs in the period in which services are received. This departure from past practice may significantly affect the operating results reported for the period of any acquisition.

IFRS 3(R) makes an exception to the general rule of charging acquisition-related costs against profit with respect to costs to register and issue equity or debt securities. These costs are to be recognized in accordance with IAS 32 and IAS 39 (or IFRS 9 if adopted). Share issuance costs are normally charged against the gross proceeds of the issuance (see Chapter 16). Debt issuance costs are treated as a reduction of the amount borrowed or as an expense of the period in which they are incurred; however, some reporting entities have treated these costs as deferred charges and amortized them against profit during the term of the debt (see Chapter 24).

### ***Post-combination measurement and accounting***

In general, in accordance with IFRS 3(R) in post-combination periods, an acquirer should measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination on the basis consistent with other applicable IFRS for those items, which include:

- IAS 38 prescribes the accounting for identifiable intangible assets acquired in a business combination;
- IAS 36 provides guidance on recognizing impairment losses;
- IFRS 4 prescribes accounting for an insurance contract acquired in a business combination;
- IAS 12 prescribes the post-combination accounting for deferred tax assets and liabilities acquired in a business combination;
- IFRS 2 provides guidance on subsequent measurement and accounting for share-based payment awards; and
- IAS 27(R) prescribes accounting for changes in a parent's ownership interest in a subsidiary after control is obtained.

IFRS 3(R) provides special guidance on accounting for the following items arising in a business combination:

1. Reacquired rights;
2. Contingent liabilities recognized as of the acquisition date;
3. Indemnification assets; and
4. Contingent consideration.

After acquisition, a *reacquired right* recognized as an intangible asset is amortized over the remaining contractual term, without taking into consideration potential renewal periods. If an acquirer subsequently sells a reacquired right to a third party, the carrying amount of the right should be included in calculating the gain or loss on the sale.

In post-combination periods, until the liability is settled, cancelled or expires, the acquirer measures a *contingent liability* recognized as of the acquisition date at the higher of:

1. The amount that would be recognized in accordance with IAS 37; and
2. The amount initially recognized, less, if appropriate, cumulative amortization recognized in accordance with IAS 18, *Revenue*.

This requirement would not apply to contracts accounted for under the provisions of IAS 39 (or IFRS 9 if adopted). In accordance with this standard, the financial liability is to be measured at fair value at each reporting date, with changes in value recognized either in profit or loss or in other comprehensive income in accordance with IAS 39 (or IFRS 9 if adopted).

At each reporting date subsequent to the acquisition date, the acquirer should measure an *indemnification asset* recognized as part of the business combination using the same basis as the indemnified item, subject to any limitations imposed contractually on the amount of the indemnification. If an indemnification asset is not subsequently measured at fair value (because to do so would be inconsistent with the basis used to measure the indemnified item), management is to assess the recoverability of the asset. Any changes in the measurement of the asset (and the related liability) are recognized in profit or loss.

The acquirer needs to carefully consider information obtained subsequent to the acquisition-date measurement of *contingent consideration*. Some changes in the fair value of contingent consideration result from additional information obtained during the measurement period that relates to the facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments to the recognized amount of contingent consideration and a corresponding adjustment to goodwill or gain from bargain purchase. However, changes that result from events occurring after the acquisition date, such as meeting a specified earnings target, reaching a specified share price, or reaching an agreed-upon milestone on a research and development project, do not constitute measurement period adjustments, and no longer result in changes to goodwill. This approach represents another significant change from past practice under original standard IFRS 3.

Changes in the fair value of contingent consideration that do not result from measurement period adjustments are to be accounted for as follows:

1. If the contingent consideration is classified as equity, it is not to be remeasured, and subsequent settlement of the contingency is to be reflected within equity.
2. If the contingent consideration is classified as an asset or liability that is a financial instrument within the scope of IAS 39 (or IFRS 9 if adopted), it is to be remeasured at fair value at each reporting date, with changes in value recognized either in profit or loss or in other comprehensive income in accordance with IAS 39 (or IFRS 9 if adopted).
3. If the contingent consideration is classified as an asset or liability that is not a financial instrument within the scope of IAS 39 (or IFRS 9 if adopted), it is to be measured in accordance with IAS 37 or other applicable standards, with changes in value recognized in profit or loss.

Since subsequent measurement and accounting for contingent consideration under IFRS 3(R) represents a significant change from former practice under the original standard IFRS 3, it is important that the management provides reliable estimates of the acquisition-date fair values. The potential impact of post-acquisition remeasurements on subsequent profit or loss as well as on debt covenants or management remuneration should be analysed at the date of acquisition.

In May 2010 the IASB amended IFRS 3 through the *Improvements Project*. The amendment relates to contingent consideration recognized by the acquirer. If a business combination takes place before the effective date of the amendment (being financial years beginning on or after July 1, 2010), then adjustments to contingent consideration that are not deemed to be part of the adjustments allowed in the measurement period are recorded against goodwill or the gain from a bargain purchase. For business combinations entered into after the effective date of the amendment, adjustments to contingent consideration that are not part of the measurement period adjustments are recognized in profit and loss.

IFRS guidance on recognizing and measuring reacquired rights, contingent liabilities and indemnification assets on the acquisition date was discussed earlier in this chapter in the paragraph entitled, “Accounting for Business Combinations under the Acquisition Method, Step 5—Classify or designate the identifiable assets acquired and liabilities assumed”; and guidance on contingent consideration in “Step 7—Measure the consideration transferred.”

## DISCLOSURE REQUIREMENTS

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The acquirer should disclose information that enables users of its financial statements to evaluate:

- The nature as well as financial effect of a business combination that occurs either: (1) during the current period, or (2) after the end of the reporting period but before the financial statements are authorized to issue;
- The financial effects of adjustments recognized in the current reporting period that relate to business combinations that occurred during: (1) the current period, or (2) previous reporting periods.

The disclosure requirements of the new standards are quite extensive and, for the reader’s convenience, are presented in detail in the disclosure checklist in Appendix A to this publication.

### *Additional guidance in applying the acquisition method*

Due to the complexity of many business combinations and the varying structures used to affect them, the IASB provided supplemental guidance to aid practitioners in applying the standard.

### *Recognizing and measuring the identifiable assets acquired and liabilities assumed*

The following guidance is to be followed in applying the recognition and measurement principles (subject to certain specified exceptions).

**Assets with uncertain cash flows (valuation allowances).** Since fair value measurements take into account the effects of uncertainty regarding the amounts and timing of future cash flows, the acquirer is not to recognize a separate valuation allowance for assets subject to such uncertainties (e.g., acquired receivables, including loans). This may be a departure from current practice, especially for entities operating in the financial services industry.

**Assets subject to operating leases in which the acquiree is the lessee.** Irrespective of whether the acquiree is the lessee or lessor, the acquirer is to evaluate, as of the acquisition date, each of the acquiree's operating leases to determine whether its terms are favourable or unfavourable compared to the market terms of leases of identical or similar items. If the acquiree is the lessee and the lease terms are favourable, the acquirer is to recognize an intangible asset; if the lease terms are unfavourable, the acquirer is to recognize a liability.

Even when the lease is considered to be at market terms, there nevertheless may be an identifiable intangible associated with it. This would be the case if market participants would be willing to pay to obtain it (i.e., to obtain the rights and privileges associated with it). Examples of this situation are leases for favourably-positioned airport gates, or prime retail space in an economically favourable location. If, from the perspective of marketplace participants, acquiring the lease would entitle them to future economic benefits that qualify as identifiable intangible assets (discussed later in this chapter), the acquirer would recognize, separately from goodwill, the associated identifiable intangible asset.

**Assets subject to operating leases in which the acquiree is the lessor.** The fair value of assets owned by the acquiree that are subject to operating leases with the acquiree being the lessor are to be measured separately from the underlying lease to which they are subject. Consequently, the acquirer does not recognize a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms, as required for leases in which the acquiree is the lessee.

**Assets the acquirer plans to idle or to use in a way that is different from the way other market participants would use them.** If the acquirer intends, for competitive or other business reasons, to idle an acquired asset (for example, a research and development intangible asset) or use it in a manner that is different from the manner in which other market participants would use it, the acquirer is still required to initially measure the asset at fair value determined in accordance with its use by other market participants.

**Identifiable intangibles to be recognized separately from goodwill.** Intangible assets acquired in a business combination are to be recognized separately from goodwill if they meet either of the two criteria to be considered *identifiable*. These criteria are:

1. *Separability criterion*—The intangible asset is capable of being separated or divided from the entity that holds it, and sold, transferred, licensed, rented or exchanged, regardless of the acquirer's intent to do so. An intangible asset meets this criterion even if its transfer would not be alone, but instead would be accompanied or bundled with a related contract, other identifiable asset, or a liability.
2. *Legal/contractual criterion*—The intangible asset results from contractual or other legal rights. An intangible asset meets this criterion even if the rights are not transferable or separable from the acquiree or from other rights and obligations of the acquiree.

Illustrative Examples to IFRS 3(R) carry forward from the original IFRS 3 a lengthy, though not exhaustive, listing of intangible assets that the IASB believes have characteristics that meet one of these two criteria (legal/contractual or separability). A logical approach in practice would be for the acquirer to first consider whether the intangibles specifically included on the IASB list are applicable to the particular acquiree and then to consider whether there may be other unlisted intangibles included in the acquisition that meet one or both of the criteria for separate recognition.



IFRS 3(R) organizes groups of identifiable intangibles into categories related to or based on:

1. Marketing;
2. Customers or clients;
3. Artistic works;
4. Contractual;
5. Technological.

These categorizations are somewhat arbitrary. Consequently, some of the items listed could fall into more than one of the categories. Examples of identifiable intangibles included in each of the categories are as follows:

#### *Marketing-related intangible assets*

1. *Trademarks, service marks, trade names, collective marks, certification marks.* A trademark represents the right to use a name, word, logo or symbol that differentiates a product from products of other entities. A service mark is the equivalent of a trademark for a service offering instead of a product. A collective mark is used to identify products or services offered by members affiliated with each other. A certification mark is used to designate a particular attribute of a product or service such as its geographic source (e.g., Columbian coffee or Italian olive oil) or the standards under which it was produced (e.g., ISO 9000 Certified).
2. *Trade dress.* The overall appearance and image (unique colour, shape or package design) of a product.
3. *Newspaper mastheads.* The unique appearance of the title page of a newspaper or other periodical.
4. *Internet domain names.* The unique name that identifies an address on the Internet. Domain names must be registered with an Internet registry and are renewable.
5. *Non-competition agreements.* Rights to assurances that companies or individuals will refrain from conducting similar businesses or selling to specific customers for an agreed-upon period of time.

#### *Customer-related intangible assets*

1. *Customer lists.* Names, contact information, order histories and other information about a company's customers, that a third party, such as a competitor or a telemarketing firm would want to use in its own business.
2. *Order or production backlogs.* Unfilled sales orders for goods and services in amounts that exceed the quantity of finished goods and work-in-process on hand for filling the orders.
3. *Customer contracts and related customer relationships.* When a company's relationships with its customers arise primarily through contracts and are of value to buyers who can "step into the shoes" of the sellers and assume their remaining rights and duties under the contracts, and which hold the promise that the customers will place future orders with the entity or relationships between entities and their customers for which:
  - a. The entities have information about the customers and have regular contact with the customers; and
  - b. The customers have the ability to make direct contact with the entity.

4. *Non-contractual customer relationships.* Customer relationships that arise through means such as regular contacts by sales or service representatives, the value of which is derived from the prospect of the customers placing future orders with the entity.

*Artistic-related intangible assets*

1. Plays, operas, ballets.
2. Books, magazines, newspapers, and other literary works.
3. Musical works such as compositions, song lyrics, and advertising jingles.
4. Pictures and photographs.
5. Video and audiovisual material including motion pictures or films, music videos and television programs.

*Contract-based intangible assets*

1. *License, royalty, standstill agreements.* License agreements represent the right, on the part of the licensee, to access or use property that is owned by the licensor for a specified period of time at an agreed-upon price. A royalty agreement entitles its holder to a contractually agreed-upon portion of the income earned from the sale or license of a work covered by patent or copyright. A standstill agreement conveys assurances that a company or individual will refrain from engaging in certain activities for specified periods of time.
2. *Advertising, construction, management, service or supply contracts.* For example a contract with a newspaper, broadcaster or Internet site to provide specified advertising services to the acquiree.
3. *Lease agreements* (irrespective of whether the acquiree is the lessee or lessor). A contract granting use or occupation of property during a specified period in exchange for a specified rent.
4. *Construction permits.* Rights to build a specified structure at a specified location.
5. *Construction contracts.* Rights to become the contractor responsible for completing a construction project and benefit from the profits it produces, subject to the remaining obligations associated with performance (including any past-due payments to suppliers and/or subcontractors).
6. *Construction management, service, or supply contracts.* Rights to manage a construction project for a fee, procure specified services at a specified fee, or purchase specified products at contractually agreed-upon prices.
7. *Broadcast rights.* Legal permission to transmit electronic signals using specified bandwidth in the radio frequency spectrum, granted by the operation of communication laws.
8. *Franchise rights.* Legal rights to engage in a trade-named business, to sell a trademarked good, or to sell a service-marked service in a particular geographic area.
9. *Operating rights.* Permits to operate in a certain manner, such as those granted to a carrier to transport specified commodities.
10. *Use rights, such as drilling, water, air, timber cutting and route authorities.* Permits to use specified land, property, or air space in a particular manner, such as the right to cut timber, expel emissions, or to land airplanes at specified gates at an airport.
11. *Servicing contracts.* The contractual right to service a loan. Servicing entails activities such as collecting principal and interest payments from the borrower,

maintaining escrow accounts, paying taxes and insurance premiums when due, and pursuing collection of delinquent payments.

12. *Employment contract.* Contract that is beneficial from the perspective of the employer because of favourable market-related terms.

#### *Technology-based intangible assets*

1. *Patented or copyrighted software.* Computer software source code, program specifications, procedures and associated documentation that is legally protected by patent or copyright.
2. *Computer software and mask works.* Software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may be provided statutory protection in some countries.
3. *Unpatented technology.* Access to knowledge about the proprietary processes and workflows followed by the acquiree to accomplish desired business results.
4. *Databases, including title plants.* Databases are collections of information generally stored digitally in an organized manner. A database can be protected by copyright (e.g., the database contained on the CD-ROM version of this publication). Many databases, however, represent information accumulated as a natural by-product of a company conducting its normal operating activities. Examples of these databases are plentiful and include title plants, scientific data and credit histories. Title plants represent historical records with respect to real estate parcels in a specified geographic location.
5. *Trade secrets.* Trade secrets are proprietary, confidential information, such as a formula, process, or recipe.

One commonly cited intangible asset deliberately omitted by the IASB from its list of identifiable intangibles is an “assembled workforce.” IASB decided that the replacement cost technique that is often used to measure the fair value of an assembled workforce does not faithfully represent the fair value of the intellectual capital acquired. It was thus decided that an exception to the recognition criteria would be made, and that the fair value of an acquired assembled workforce would remain part of goodwill.

**Research and development assets.** IFRS 3(R) requires the acquirer to recognize and measure all tangible and intangible assets used in research and development (R&D) activities acquired individually or in a group of assets as part of the business combination. This prescribed treatment is to be followed even if the assets are judged to have no alternative future use. These assets are to be measured at their acquisition-date fair values. Fair value measurements are to be made based on the assumptions that would be made by market participants in pricing the asset. Assets that the acquirer does not intend to use or intends to use in a manner that is different from the manner in which other market participants would use them are, nevertheless, required to be measured at fair value.

*Intangible R&D assets.* Upon initial recognition, the *intangible* R&D assets are to be classified as indefinite-life assets until the related R&D efforts are either completed or abandoned. In the reporting periods during which the R&D intangible assets are classified as indefinite-life, they are not to be amortized. Instead, they are to be tested for impairment in the same manner as other indefinite-life intangibles. Upon completion or abandonment of the related R&D efforts, management is to determine the remaining useful life of the intangibles and amortize them accordingly. In applying these requirements, assets that are temporarily idled are not to be considered abandoned.

*Tangible R&D assets.* Tangible R&D assets acquired in a business combination are to be accounted for according to their nature (e.g., supplies, inventory, depreciable assets, etc.).

***Determining what is part of the business combination transaction***

Transactions entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners), before the combination, are likely to be separate transactions, not accounted for under the acquisition method. In applying the acquisition method to account for a business combination, the acquirer must recognize only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. IFRS 3(R) provides the following examples of separate transactions that are not to be included in applying the acquisition method:

1. A transaction that in effect settles pre-existing relationships between the acquirer and acquiree;
2. A transaction that remunerates employees or former owners of the acquiree for future services; and
3. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

The amount of the gain or loss measured as a result of settling a pre-existing relationship will, of course, depend on whether the acquirer had previously recognized related assets or liabilities with respect to that relationship.

**Example of settlement of pre-existing contractual supplier relationship; contract unfavourable to acquirer**

Konin Corporation (KC) and Banham Corporation (BC) are parties to a 3-year supply contract that contains the following provisions:

1. KC is required to annually purchase 3,000 flat-panel displays from BC at a fixed price of €400 per unit for an aggregate purchase price of €1,200,000 for each of the three years.
2. KC is required to pay BC the annual €1,200,000 irrespective of whether it takes delivery of all 3,000 units and the required payment is non-refundable.
3. The contract contains a penalty provision that would permit KC to cancel it at the end of the second year for a lump-sum payment of €500,000.
4. In each of the first two years of the contract, KC took delivery of the full 3,000 units.

At December 31, 20XX-1, the supply contract was unfavourable to KC because KC was able to purchase flat-panel displays with similar specifications and of similar quality from another supplier for €350 per unit. Therefore, KC accrued a loss of €150,000 (3,000 units remaining under the firm purchase commitment × €50 loss per unit).

On January 1, 20XX, KC acquires BC for €30 million, which reflects the fair value of BC based on what other marketplace participants would be willing to pay. On the acquisition date, the €30 million fair value of BC includes €750,000 related to the contract with KC that consists of

Identifiable intangibles <sup>3</sup>	€600,000	Representing the remaining year of the contract, at prevailing market prices
Favourable pricing	150,000	Representing the portion of the contract price that is favourable to BC and unfavourable to KC
	€750,000	

BC has no other identifiable assets or liabilities related to the supply contract with KC. KC would compute its gain or loss on settlement of this pre-existing relationship as follows:

1. Amount of unfavourableness to acquirer (KC) at acquisition date	€150,000
2. Lump-sum settlement amount available to KC	500,000
3. Lesser of 1. or 2.	150,000
4. Amount by which 1. exceeds 2.	N/A

Since KC had already recognized an unrealized loss on the firm purchase commitment as of December 31, 20XX, upon its acquisition of BC, its loss of €150,000 from recognizing the lesser of 1. and 2. above would be offset by the elimination of the liability for the unrealized loss on the firm purchase commitment in the same amount of €150,000. Thus, under these circumstances, KC would have neither a gain nor a loss on the settlement of its pre-existing relationship with BC. The entries to record these events are not considered part of the business combination accounting. It is important to note that, from the perspective of KC, when it applies the acquisition method to record the business combination, it will characterize the €600,000 “at-market” component of the contract as part of goodwill and not as identifiable intangibles. This is the case because of the obvious fallacy of KC recognizing customer-relationship intangible assets that represent a relationship with itself.

**Example of settlement of pre-existing contractual supplier relationship; contract favourable to acquirer**

Using the same facts as the KC/BC example above, assume that, instead of the contract being favourable to the acquirer KC, it was unfavourable to BC in the amount of €150,000 and that there was a cancellation provision in the contract that would permit BC to pay a penalty after year two of €100,000 to cancel the remainder of the contract.

On the acquisition date, the €30 million fair value of BC, under this scenario would include €450,000 related to the contract with KC that consists of<sup>3</sup>

Identifiable intangibles	€600,000	Representing the remaining year of the contract. at prevailing market prices
Unfavourable pricing	(150,000)	Representing the portion of the contract price that is unfavourable to BC and favourable to KC
	€450,000	

Under these changed assumptions, KC would not have incurred or recorded an unrealized loss on the firm purchase commitment with BC since the contract terms were favourable to KC. The determination of KC’s gain or loss would be as follows:

1. Amount of favourability to acquirer (KC) at acquisition date	€150,000
2. Lump-sum settlement amount available to BC	100,000
3. Lesser of 1. or 2.	100,000
4. Amount by which 1. exceeds 2.	50,000

Under this scenario, unless BC believed that the market would change in the near term, it would be economically advantageous, in the absence of a business combination, for BC to settle the remaining contract at the acquisition date by paying the €100,000 penalty because BC would be able to sell the remaining 3,000 units covered by the contract for an aggregate price of €150,000 more than it was committed to sell those units to KC.

At the acquisition date, KC would record a gain of €100,000 to settle its pre-existing relationship with BC. The entry to record the gain is not considered part of the business combination accounting.

In addition, however, since 2. is less than 1., the €50,000 difference is included in the accounting for the business combination, since economically, in post-combination periods, the combined entity will not benefit from that portion of the acquisition date favourability of the contract.

As was the case in the first example, the portion of the purchase price allocated to the contract in the business combination accounting would be accounted for as goodwill for the same reason.

**Contingent payments to employees or former owners of the acquiree.** The acquirer is to assess whether arrangements to make contingent payments to employees or selling owners of the acquiree represent contingent consideration that is part of the business combination transaction or represent separate transactions to be excluded from the application of the acquisition method to the business combination. In general, the acquirer is to consider the reasons why the terms of the acquisition include the payment provision, the party that initiated the arrangement, and when (at what stage of the negotiations) the arrangement was entered into by the parties. When those considerations do not provide clarity regarding whether the transaction is separate from the business combination, the acquirer considers the following indicators:

1. *Post-combination employment*—Consideration is to be given to the terms under which the selling owners will be providing services as key employees of the combined entity. The terms may be evidenced by a formal employment contract, by provisions included in the acquisition documents, or by other documents. If the arrangement provides that the contingent payments are automatically forfeited upon termination of employment, the consideration is to be characterized as compensation for post-combination services. If, instead, the contingent payments are not affected by termination of employment, this would be an indicator that the contingent payments represent additional consideration that is part of the business combination transaction and not compensation for services.
2. *Duration of post-combination employment*—If the employee is contractually bound to remain employed for a period that equals or exceeds the period during which the contingent payments are due, this may be an indicator that the contingent payments represent compensation for services.
3. *Amount of compensation*—If the amount of the employee's compensation that is not contingent is considered to be reasonable in relation to other key employees of the combined entity, this may indicate that the contingent amounts represent additional consideration and not compensation for services.
4. *Differential between amounts paid to employees and selling owners who do not become employees of the combined entity*—If, on a per-share basis, the contingent payments due to former owners of the acquiree that did not become employees are lower than the contingent payments due to the former owners that did become employees of the combined entity, this may indicate that the incremental amounts paid to the employees are compensation.
5. *Extent of ownership*—The relative ownership percentages (e.g., number of shares, units, percentage of membership interest) owned by the selling owners who remain employees of the combined entity serve as an indicator of how to characterize the substance of the contingent consideration. If, for example, the former owners of substantially all of the ownership interests in the acquiree are continuing to serve as key employees of the combined entity, this may be an indicator that the contingent

payment arrangement is substantively a profit-sharing vehicle designed with the intent of providing compensation for services to be performed post-combination. Conversely, if the former owners that remained employed by the combined entity collectively owned only a nominal ownership interest in the acquiree and all of the former owners received the same amount of contingent basis on a per-share basis, this may be an indicator that the contingent payments represent additional consideration. In considering the applicability of this indicator, care must be exercised to closely examine the effects, if any, of transactions, ownership interests, and employment relationships, pre-combination and post-combination, with respect to parties related to the selling owners of the acquiree.

6. *Relationship of contingent arrangements to the valuation approach used*—The payment terms negotiated in many business combinations provide that the amount of the acquisition date transfer of consideration from acquirer to acquiree (or the acquiree's former owners) is computed near the lower end of a range of valuation estimates the acquirer used in valuing the acquiree. Furthermore, the formula for determining future contingent payments is derived from or related to that valuation approach. When this is the case, it may be an indicator that the contingent payments represent additional consideration. Conversely, if the formula for determining future contingent payments more closely resembles prior profit-sharing arrangements, this may be an indicator that the substance of the contingent payment arrangement is to provide compensation for services.
7. *Formula prescribed for determining contingent consideration*—Analysing the formula to be used to determine the contingent consideration may provide insight into the substance of the arrangement. Contingent payments that are determined on the basis of a multiple of earnings may be indicative of being, in substance, contingent consideration that is part of the business combination transaction. Alternatively, contingent consideration that is determined as a prespecified percentage of earnings would be more suggestive of a routine profit-sharing arrangement for the purposes of providing additional compensation to employees for post-combination services rendered.
8. *Other considerations*—Given the complexity of a business combination transaction and the sheer number and girth of the legal documents necessary to effect it, the financial statements preparer is charged with the daunting, but unavoidable task of performing a comprehensive review of the terms of all the associated agreements. These can take the form of non-compete agreements, consulting agreements, leases, guarantees, indemnifications, and, of course, the formal agreement to combine the businesses. Particular attention should be paid to the applicable income tax treatment afforded to the contingent payments. The income tax treatment of these payments may be an indicator that tax avoidance was a primary motivator in characterizing them in the manner that they are structured. An acquirer might, for example, simultaneous to a business combination, execute a property lease with one of the key owners of the acquiree. If the lease payments were below market, some or all of the contingent payments to that key owner/lessor under the provisions of the other legal agreements might, in substance, be making up the shortfall in the lease and thus should be recharacterized as lease payments and accounted for separately from the business combination in the combined entity's post-combination financial statements. If this were not the case, and the lease payments were reflective of the market,

this would be an indicator pointing to a greater likelihood that the contingent payment arrangements actually did represent contingent consideration associated with the business combination transaction.

#### Example of contingent payments to employees

Henan Corporation (HC) hired a new Accounting Director in charge of the conversion to IFRS under a five-year contract. The terms of the contract stated that HC will pay the Director €1 million annually if HC is acquired before the expiration of this contract, up to the maximum amount of €5 million. After four years, Konin Corporation (KC) acquires HC. Since the Director was still working for HC at the acquisition date, he will receive €1 million payment under the contract.

In this example, the contract for the employment of the Accounting Director was entered into much before the negotiations of the business combination were initiated, and the purpose of the contract was to receive the services of the Director. Therefore, there is no evidence that this contract was primarily entered into to provide benefits to KC or the combined entity. As a result, the liability for the payment of €1 million is included in the application of the acquisition method.

Alternatively, HC might enter into the contract at the recommendation of KC, as part of the negotiations for the business combination, with the intent to provide severance pay to the Director. Therefore, the contract may primarily benefit KC and the combined entity rather than HC or its former owners. Consequently, the acquirer KC must account for the liability of €1 million to the Director since the payment is considered a separate transaction, excluded from the application of the acquisition method to this business combination.

**Replacement awards—Acquirer share-based payment awards exchanged for acquiree awards held by its employees.** In connection with a business combination, the acquirer often awards share options or other share-based payments (i.e., replacement awards) to the employees of the acquiree in exchange for the employees' acquiree awards. Obviously, there are many valid business reasons for the exchange, not the least of which is ensuing smooth transition and integration, retention and motivation of valued employees, and maintaining controlling interests in the acquiree.

IFRS 3(R) provides guidance on determining whether equity instruments (for example, share-based payments awards) issued in a business combination are part of the consideration transferred in exchange for control of the acquiree (and accounted for in accordance with IFRS 3[R]) or are in return for continued service in the post-combination periods (and accounted for under IFRS 2, *Share-Based Payment*, as a modification of a plan).

*Acquirer not obligated to exchange.* Accounting for the replacement awards under IFRS 3(R) is dependent on whether the acquirer is obligated to replace the acquiree awards. The acquirer is obligated to replace the acquiree awards if the acquiree or its employees can enforce replacement through rights obtained from the terms of the acquisition agreement, the acquiree awards, or applicable laws or regulations.

If the acquirer is not obligated to replace the acquiree awards, all of the market-based measure (MBM) of the replacement awards is recognized as remuneration cost in the post-combination financial statements.

## Goodwill and Gain from a Bargain Purchase

### *Goodwill*

Goodwill represents the difference between the acquisition-date fair value of the consideration transferred plus the amount of any non-controlling interest in the acquiree



plus the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and the acquisition-date fair values of the identifiable assets acquired and liabilities assumed. It is presumed that when an acquiring entity pays such a premium price for the acquiree, it sees value that transcends the worth of the tangible assets and the identifiable intangibles, or else the deal would not have been consummated on such terms. This goodwill arising from acquisitions often consists largely of the synergies and economies of scale expected from combining the operations of the acquirer and acquiree. Goodwill must be recognized as an asset.

The balance in the goodwill account should be reviewed at the end of each reporting period to determine whether the asset has suffered any impairment. If goodwill is no longer deemed probable of being fully recovered through the profitable operations of the acquired business, it should be partially written down or fully written off. Any write-off of goodwill must be charged to profit and loss. Once written down, goodwill cannot later be restored as an asset, again reflecting the concern that the independent measurement of goodwill is not possible and the acquired goodwill may, in the post-acquisition periods, be replaced by internally generated goodwill, which is not to be recognized.

It should be noted that in acquisitions of less than 100% of the equity interests, IFRS 3 (R) provides the acquirer with a choice of two options to measure non-controlling interests arising in a business combination:

1. To measure the non-controlling interest at *fair value* (also recognizing the acquired business at fair value); or
2. To measure the non-controlling interest at the non-controlling interest's share of the value of net assets acquired.

Under the fair value approach to measure non-controlling interest, the acquired business will be recognized at fair value, with the controlling share of total goodwill assigned to the controlling interest and the non-controlling share allocated to the non-controlling interest. Under the second approach to measure non-controlling interest, while the net identifiable assets attributable to the non-controlling interest are written up to the fair values implied by the acquisition transaction, goodwill will not be imputed for the non-controlling share.

#### Example of acquisition transaction—goodwill

Oman Heating Corp. acquired 100% the equity interests of Euro Boiler Manufacturing Co. on January 2, 20XX, in exchange for cash of €15 million and the balance represented by a long-term note to former Euro shareholders. As of January 2, 20XX, immediately prior to the transaction, Euro's statement of financial position is as follows, with both book and fair values indicated (in thousands of €):

	<i>Book</i> <u>value</u>	<i>Fair</i> <u>value</u>		<i>Book</i> <u>Fair</u>	<i>Fair</i> <u>value</u>
Cash	€ 1,000	€ 1,000	Current liabilities	€26,200	€26,200
Accounts receivable, net	12,200	12,000	Long-term debt	46,000	41,500
Inventory	8,500	9,750	Guarantee of debt	--	75
Other current assets	500	500			
Property, plant and equipment, net	38,500	52,400			

Customers list	--	1,400			
Patents	2,400	3,900			
In-process research and development	--	<u>8,600</u>	Shareholders' equity	(9,100)	<u>21,775</u>
			(deficit)		
Totals		<u>€63,100</u>	<u>€89,550</u>	<u>€63,100</u>	<u>€89,550</u>

The fair value of inventory exceeded the corresponding book value because Euro Boiler had been using LIFO for many years to cost its inventory, prior to revised IAS 2's banning this method, and actual replacement cost was therefore somewhat higher than carrying value at the date of the acquisition. The long-term debt's fair value was slightly lower than carrying value (cost) because the debt carries a fixed interest rate and the market rates have risen since the debt was incurred. Consequently, Euro Boiler benefits economically by having future debt service requirements which are less onerous than they would be if it were to borrow at current rates. Conversely, of course, the fair value of the lender's note receivable has declined since it now represents a loan payable at less than market rates. Finally, the fair values of Euro Boiler's receivables have also declined from their carrying amount, due to both the higher market rates of interest and to the greater risk of non-collectibility because of the change in ownership. The higher interest rates impact the valuation in two ways: (1) when computing the discounted present value of the amounts to be received, the higher interest rate reduces the computed present value, and (2) the higher interest rates may serve as an incentive for customers to delay payments to Euro rather than borrow the money to repay the receivables, with that delay resulting in cash flows being received later than anticipated thus causing the present value to decline.

Euro Boiler's customer list has been appraised at €1.4 million and is a major reason for the company's acquisition by Oman Heating. Having been internally developed over many years, the customer list is not recorded as an asset by Euro, however. The patents have been amortized down to 62.4 million in Euro Boiler's accounting records, consistent with IFRS, but an appraisal finds that on a fair value basis the value is somewhat higher.

Similarly, property, plant and equipment has been depreciated down to a book value of €38.5 million, but has been appraised at a sound value (that is, replacement cost new adjusted for the fraction of the useful life already elapsed) of €52.4 million.

A key asset being acquired by Oman Heating, albeit one not formally recognized by Euro Boiler, is the in-process research and development (IPR&D), which pertains to activities undertaken over a period of several years aimed at making significant process and product improvements which would enhance Euro Boiler's market position and will be captured by the new combined operations. It has been determined that duplicating the benefits of this ongoing R&D work would cost Oman Heating €8.6 million. The strong motivation to make this acquisition, and to pay a substantial premium over book value, is based on Euro Boiler's customer list and its IPR&D. Euro Boiler has previously expensed all R&D costs incurred, as required under IFRS, since it conservatively believed that these costs were in the nature of research, rather than development.

Euro Boiler had guaranteed a €1.5 million bank debt of a former affiliated entity, but this was an "off the books" event since guarantees issued between corporations under common control were commonly deemed exempt from recognition. The actual contingent obligation has been appraised as having a fair value (considering both the amount and likelihood of having to honour the commitment) of €75,000.

Thus, although Euro Boiler's statement of financial position reflects a shareholders' deficit (including share capital issued and outstanding, and accumulated deficit) of €9.1 million, the value of the acquisition, including the IPR&D, is much higher. The preliminary computation of goodwill is as follows:

Consideration transferred		€32,000,000
Net working capital	€(2,950,000)	
Property, plant, and equipment	52,400,000	
Customer list	1,400,000	
Patents	3,900,000	
In-process research and development	8,600,000	
Guarantee of indebtedness of others	(75,000)	
Long-term debt	(41,500,000)	21,775,000
Goodwill		€10,225,000

Under IFRS 3(R), the fair value allocated to the in-process research and development must be expensed unless it is separately identifiable, is a resource that is controlled, is a probable source of future economic benefits, and has a reliably measurable fair value. Oman Heating determines that €1,800,000 of the cost of IPR&D meets all these criteria and supports capitalization. All other assets and liabilities are recorded by Oman Heating at the allocated fair values, with the excess consideration transferred being assigned to goodwill. The entry to record the acquisition (for preparation of consolidated financial statements, for example) is as follows:

Cash	1,000,000	
Accounts receivable, net	12,000,000	
Inventory	9,750,000	
Other current assets	500,000	
Property, plant and equipment	52,400,000	
Customer list	1,400,000	
Patents	3,900,000	
Development costs capitalized	1,800,000	
Research and development expense	6,800,000	
Goodwill	10,225,000	
Current liabilities		26,200,000
Guarantee of indebtedness of others		75,000
Long-term debt		41,500,000
Notes payable to former shareholders		17,000,000
Cash		15,000,000

Note that, while the foregoing example is for a share acquisition, an asset and liability acquisition would be accounted for in the exact same manner. Also, since the debt is recorded at fair value, which will often differ from face (maturity) value, the differential (premium or discount) must be amortized using the effective yield method from acquisition date to the maturity date of the debt, and thus there will be differences between actual payments of interest and the amounts recognized in profit or loss as interest expense. Finally, note that property, plant and equipment is recorded “net”—that is, the allocated fair value becomes the “cost” of these assets; accumulated depreciation previously recorded in the accounting records of the acquired entity does not carry forward to the post-acquisition financial statements of the consolidated entity.

### ***Impairment of goodwill***

Assume that an entity acquires another entity and that goodwill arises from this acquisition. Also assume that, for purposes of impairment, it is determined that the acquired business comprises seven discrete cash-generating units. A cash-generating unit is the smallest level of identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets (not larger than an operating segment). The goodwill recorded on the acquisition must be allocated to some or

all of those seven cash-generating units. If it is the case that the goodwill is associated with only some of the seven cash-generating units, the goodwill recognized in the statement of financial position should be allocated to only those assets or groups of assets.

Three steps are required for goodwill impairment testing. First, the recoverable amount of a *cash-generating unit* which is the higher of the cash-generating unit's fair value less costs to sell (net selling price) and its value in use, which is the present value of the estimated future cash flows expected to be derived from the cash-generating unit, must be determined. Second, the recoverable amount of the cash-generating unit is compared to its carrying value. If the recoverable value exceeds the carrying value, then there is no goodwill impairment, and the third testing step is not required.

IAS 36 requires that if the recoverable amount is less than the carrying value, an impairment write-down must be made. In this third step in goodwill impairment testing, the recoverable value of the cash-generating unit as of the testing date is allocated to its assets (including intangible assets) and liabilities, with the remainder (if any) being assigned to goodwill. If the amount of goodwill resulting from this calculation is less than the carrying amount of goodwill, then the difference is impaired goodwill and must be charged to expense in the current period.

An impairment loss is first absorbed by goodwill, and only when goodwill has been eliminated entirely is any further impairment loss credited to other assets in the group (on a pro rata basis, unless it is possible to measure the recoverable amounts of the individual assets). This is perhaps somewhat arbitrary, but it is also logical, since the excess earnings power represented by goodwill must be deemed to have been lost if the recoverable amount of the cash-generating unit is less than its carrying amount. It is also a conservative approach, and will diminish or eliminate the display of that often misunderstood and always suspiciously viewed asset, goodwill, before the carrying values of identifiable intangible and tangible assets are adjusted.

### ***Reversal of previously recognized impairment of goodwill***

In general under IFRS, reversal of an impairment identified with a cash-generating unit is permitted. However, due to the special character of this asset, IAS 36 has imposed a requirement that reversals may not be recognized for previous write-downs in goodwill. Thus, a later recovery in the value of the cash-generating unit will be allocated to assets other than goodwill. (The adjustments to those assets cannot be for amounts greater than would be needed to restore them to the carrying amounts at which they would be currently stated had the earlier impairment not been recognized—i.e., at the former carrying values less the depreciation that would have been recorded during the intervening period.)

IFRIC 10, *Interim Financial Reporting and Impairment*, addresses conflicts between the requirements of IAS 34, *Interim Financial Reporting*, and those in other standards on the recognition and reversal in the financial statements of impairment losses on goodwill and certain financial assets. In conformity with IFRIC 10, any impairment losses recognized in an interim financial statement must not be reversed in subsequent interim or annual financial statements.

### ***Gain from a bargain purchase***

In certain business combinations, the consideration transferred is less than the fair value of the net assets acquired. These are often identified as being “bargain purchase” transactions. This difference has traditionally (if illogically) been referred to as “negative goodwill.”

IFRS 3(R) suggests that, since arm's-length business acquisition transactions will usually favour neither party, the likelihood of the acquirer obtaining a bargain is considered remote. According to this standard, apparent instances of bargain purchases giving rise to a gain from a bargain purchase are more often the result of a measurement error (i.e., where the fair values assigned to assets and liabilities were incorrect to some extent) or of a failure to recognize a contingent or actual liability (such as for employee severance payments). However, a gain from a bargain purchase can also derive from the risk of future losses, recognized by both parties and incorporated into the transaction price. (One such example was the case of the sale by BMW of its Rover car division to a consortium for £1. It did indeed suffer subsequent losses and eventually failed.)

IFRS 3(R) requires that, before a gain from a bargain purchase is recognized, the allocation of fair values is to be revisited, and that all liabilities—including contingencies—are to be reviewed; the consolidation transferred is reviewed and for a business combination achieved in stages, the acquirer's previously held interest in the acquiree is also revisited. After this is completed, if indeed the fair values of identifiable assets acquired net of all liabilities assumed, exceeds the total consideration transferred, then a gain from a bargain purchase will be acknowledged. The accounting treatment of negative goodwill has passed through a number of evolutionary stages beginning with the original IAS 22, which was later twice revised with major changes to the prescribed accounting treatment of negative goodwill.

Under IFRS 3(R), a gain from a bargain purchase is taken immediately into profit. Essentially, this is regarded, for financial reporting purposes, as a gain realized upon the acquisition transaction, and accounted for accordingly.

#### Example of acquisition transaction—gain from a bargain purchase

Hoegedorn Corp. acquires, on March 4, 20XX, all of the outstanding ordinary shares of Gemutlichkeit Co. in exchange for cash of €800,000. A formerly successful entity, Gemutlichkeit had recently suffered from declining sales and demands for repayment of its outstanding bank debt, which were threatening its continued existence. Hoegedorn management perceived an opportunity to make a favourable purchase of a company operating in a related line of business, and accordingly made this modest offer, which was accepted by the shareholders of Gemutlichkeit, the acquiree. Gemutlichkeit's statement of financial position at the date of acquisition is as follows, with both book and fair values indicated (in thousands of €):

	<i>Book value</i>	<i>Fair value</i>		<i>Book value</i>	<i>Fair value</i>
Cash	€800	€800	Current liabilities	€2,875	€2,875
Accounts receivable, net	3,600	3,400	Long-term debt	11,155	11,155
Inventory	1,850	1,800			
Property, plant and equipment	6,800	7,200			
Net operating loss carryforwards	--	2,400	Shareholders' equity (deficit)	(980)	1,570
<b>Totals</b>	<b>€13,050</b>	<b>€15,600</b>		<b>€13,050</b>	<b>€15,600</b>

Gemutlichkeit had provided a valuation allowance for the deferred income tax asset attributable to the net operating loss carryforward tax benefit, since recurring and increasing losses made it probable that these benefits would not be realized, consistent with IFRS (IAS 12). Hoegedorn Corp., which is highly profitable, is in the same line of business, and intends to continue

Gemutlichkeit's operation, expects to be able to realize these benefits, and therefore will have no valuation allowance against this asset.

Thus, although Gemutlichkeit's statement of financial position reflects a shareholders' deficit (including share capital and accumulated deficit in retained earnings) of €980,000, the value of the acquisition is much higher, and furthermore the acquirer is able to negotiate a bargain purchase. The preliminary computation of the gain on a bargain purchase is as follows:

Net working capital	€3,125,000	
Property, plant and equipment	7,200,000	
Net operating loss carryforward	2,400,000	
Long-term debt	(11,155,000)	1,570,000
Consideration transferred		800,000
Gain from bargain purchase		€ 770,000

IFRS 3(R) requires that a gain from a bargain purchase be taken into profit or loss immediately, after first verifying that all acquired or assumed liabilities, including contingencies, have been fully accounted for, and that assets acquired were not overstated. In the present example, these matters were reviewed and the amounts shown above were fully supported.

The entry to record the acquisition is therefore as follows:

Cash	800,000	
Accounts receivable, net	3,400,000	
Inventory	1,800,000	
Property, plant and equipment	7,200,000	
Deferred income tax asset	2,400,000	
Current liabilities	2,875,000	
Long-term debt		11,155,000
Cash		800,000
Gain from bargain purchase		770,000

### ***Business combinations achieved in stages (step acquisitions)***

A step acquisition is a business combination in which the acquirer held an equity interest in the acquiree prior to the acquisition date on which it obtained control. In some instances, control over another entity is not achieved in a single transaction, but rather, after a series of transactions. For example, one entity may acquire a 25% interest in another entity, followed by another 20% some time later, and then followed by another 10% at yet a later date. The last step gives the acquirer a 55% interest and, thus, control. The accounting issue is to determine at what point in time the business combination took place and how to measure the acquisition.

IFRS 3(R) requires the acquirer to remeasure its previous holdings of the acquiree's equity at acquisition-date fair value. Any gain or loss on remeasurement is recognized in profit or loss on that date.

#### **Example of a step acquisition**

On December 31, 20XX-1, Konin Corporation (KC) owns 5% of the 30,000 outstanding voting common shares of Henan Corporation (HC). On KC's December 31, 20XX-1 statement of financial position, it classified its investment in HC as available-for-sale. On March 31, 20XX, KC acquired additional equity shares in HC sufficient to provide KC with a controlling interest in HC and, thus, become HC's parent company.

The following table summarizes KC's initial holdings in HC, the subsequent increase in those holdings, and the computation of the gain on remeasurement at the acquisition date of March 31, 20XX:

<u>Date</u>	<u># of Shares</u>	<u>Percent interest</u>	<u>per share</u>		<u>Aggregate investment</u>		<i>Unrealized appreciation included in accumulated other comprehensive income</i>
			<u>Cost</u>	<u>Fair value</u>	<u>Cost</u>	<u>Fair value</u>	
12/31/20XX-1	1,500	5%	\$10	\$16	\$15,000	\$24,000	<u>\$9,000</u>
3/31/20XX	<u>21,000</u>	<u>70%</u>	20	20	420,000	420,000	
	<u>22,500</u>	<u>75%</u>					

Computation of gain (loss) on remeasurement at acquisition date:

Fair value per share on 3/31/20XX	\$ 20
Number of pre-acquisition shares	× 1,500
Aggregate fair value of pre-acquisition shares on 3/31/20XX	30,000
Carrying amount of pre-acquisition shares on 3/31/20XX	24,000
Appreciation attributable to the 1st quarter of 20XX	6,000
Pre-20XX appreciation reclassified from accumulated OCI	<u>9,000</u>
Gain on remeasurement of HC stock on 3/31/20XX	\$15,000

If the acquirer had previously recognized changes in the carrying value of its equity interest in the acquiree in other comprehensive income (e.g., because the investment was classified as available-for-sale), that amount is to be reclassified and included in the computation of the acquisition date gain or loss from remeasurement.

### Footnote Disclosure: Acquisitions

IFRS 3(R) provides an illustrative example of footnote disclosures about acquisitions which an acquirer should present in the financial statements.

#### Footnote XX: Acquisitions

On March 30, 20XX-1, Konin Corporation (KC) acquired 10% of the outstanding ordinary shares of Henan Corporation (HC). On September 30, 20XX KC acquired 65% of the outstanding ordinary shares of HC and obtained control of HC. HC is the provider of electrical distribution products and as a result of the acquisition, KC is expected to be the leading provider of energy sufficiency solutions in Central and Eastern Europe.

The goodwill of €2,500 arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of KC and HC. None of the goodwill recognized is expected to be deductible for income tax purposes.

The following information summarizes the consideration paid for HC and the fair values of the assets acquired and liabilities assumed, recognized at the acquisition date, as well as the acquisition date fair value of the non-controlling interest in HC.

#### Consideration (at September 30, 20XX)

Cash	€5,000
Equity instruments (65,000 ordinary shares of KC)	6,500
Contingent consideration	1,000
Total consideration transferred	12,500

Fair value of KC's equity interest in HC held before the business combination	2,000
	14,500
<b>Acquisition-related costs</b> (included in selling, general and administrative expenses in KC's statement of comprehensive income for the year ended December 31, 20XX)	1,100
<b>Recognized amounts of identifiable assets acquired and liabilities assumed</b>	
Financial assets	4,000
Inventory	3,000
Property, plant and equipment	9,000
Identifiable intangible assets	2,500
Total assets	18,500
Financial liabilities	(3,500)
Contingent liability	(1,000)
Total identifiable net assets	14,000
Non-controlling interest in HC	(3,500)
Goodwill	4,000
	14,500

The fair value of the 65,000 ordinary shares issued as part of the consideration paid for HC (€6,500) was determined on the basis of the acquisition-date closing market price of KC's ordinary shares.

The contingent consideration arrangement requires KC to pay the former owners of HC 4% of the revenues of HC in excess of €25,000 for 20XX, up to a maximum amount of €2,000 (undiscounted). The potential undiscounted amount of all future payments that KC could be required to make under the contingent consideration arrangement is between €0 and €2,000. The fair value of the contingent consideration arrangement (€1,000) was estimated by applying the income approach. The fair value estimates are based on an assumed discount rate range of 15–20% and assumed probability-adjusted revenues in HC of €20,000–€30,000. As of December 31, 20XX, the amount recognized for the contingent consideration and the range of outcomes and assumptions used to develop the estimates have not changed.

The fair value of the financial assets acquired includes receivables from industrial control services provided to a new customer. The gross amount due under the contracts is €2,100 of which €250 is expected to be uncollectible.

The fair value of the acquired identifiable intangibles assets (licenses) of €2,500 is based on a receipt of the final valuations for those assets.

A contingent liability of €1,000 has been recognized for expected future services to satisfy warranty claims on industrial control products sold by HC during the last four years. It is expected that the majority of this expenditure will be incurred in 20XX+1 and that all will be incurred by the end of 20XX+2. The estimate of potential undiscounted amount of all future payments that HC could be required to make under the warranty claims is between €750 and €1,250. As of December 31, 20XX, there has been no change since September 30, 20XX, in the amount estimated for the liability or any change in the range of outcomes or assumptions used to develop the estimates.

The fair value of the non-controlling interest in HC, an unlisted company, was estimated by applying a market approach and an income approach. The fair value estimates are based on:

1. An assumed discount rate range of 15–20%;
2. An assumed terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long-term sustainable growth rates ranging from 3 to 6%);
3. Assumed financial multiples of companies deemed to be similar to HC; and



4. Assumed adjustments because of the lack of control or lack of marketability that market participants would consider when estimating the fair value of the non-controlling interest in HC.

KC recognized a gain of €500 as a result of measuring at fair value its 15% equity interest in HC held before the business combination. The gain is included in other income in KC's statement of comprehensive income for the year ending December 31, 20XX.

The revenue included in the consolidated statement of comprehensive income since September 30, 20XX, contributed by HC was €5,550 and profit of €1,100 was generated over the same period. HC reported revenue of €20,200 and profit of €3,910 for 20XX.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

### Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX

#### 25 Business combinations

##### 25.1 Subsidiaries acquired

20XX	Principal activity	Date of acquisition	Proportion of shares acquired	Consideration transferred
Company A	Manufacturing	01 February 20XX	100%	X
Company B	Distribution	01 April 20XX	100%	X
(France)				X

Company A was acquired to expand the production capabilities of the group to enable it to supply to rapidly expanding markets.

The acquisition of company B has significantly improved the distribution network of the group in France and its neighbouring countries.

Goodwill represents the value of the synergies arising from the economies of scale achievable in the enlarged group. These synergistic benefits were the primary reason for entering into the business combination. The total amount of goodwill that is expected to be deductible for tax purposes is £X. The amount of the new subsidiaries' profits or losses since the acquisition date included in the group profit or loss for the period is £X.

##### 25.2 Consideration transferred

	Company A	Company B
	£	£
Cash	X	X
Deferred consideration (payable in cash)	X	X
Contingent consideration arrangement (a)	X	X
Equity issued	X	X
	<u>X</u>	<u>X</u>

(a) The agreement requires the Group to pay the vendors an additional amount of £xx, if the profit of Company A exceeds £X in the year following acquisition. The average profit for the last three years amounted to £X. The directors are of the opinion that the profit will exceed the target set.

Other costs relating to the acquisition of the subsidiaries have not been included in the consideration and have been recognized as an expense. This expense is included in administration expenses.

### 25.3 Assets acquired and liabilities assumed at the date of acquisition

	Company A	Company B
	£	£
Current assets	X	X
Cash and & cash equivalents	X	X
Trade and other receivables	X	X
Inventories	X	X
Plant and equipment	X	X
Trade and other payables	X	X
Contingent liabilities	X	X
	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>

The initial accounting for the acquisition of Company B has only been provisionally determined at the end of the reporting period. At the date of finalization of these financial statements, the necessary market valuations and other calculations had not been finalized and they have therefore only been provisionally determined based on the directors' best estimates.

IFRS3 B67(a)

### 25.4 Non-controlling interest

The non-controlling interests of Company A and Company B at the date of acquisition was measured at the fair value of these interests. This fair value was estimated by applying a discounted income approach, and amounted to £X. Key assumptions and made and inputs used were:

IFRS3 B64(0)

- discount rate 14%;
- sustainable growth rates 4%

### 25.5 Impact of acquisitions on the results of the Group

The contribution to net profit of the group was £X by Company A, and £X by Company 8 respectively. Group revenue includes £X from the operations of Company A and £X from company B.

IFRS3 B64

If these businesses were acquired at the beginning of the reporting period" Group revenue would have been £X, and profit for the year from continuing operations would have been £X. The directors of the Group consider these results to be representative of the performance of the combined group, annualized and provide a reference point for comparison against periods in the future.

IFRS3 p61

The abovementioned “annualized” contributions were calculated from actual results of the companies and adjusted for the following:

- depreciation of plant and equipment acquired based on the fair values determined rather than the carrying amounts recognized in the pre-acquisition financial statements;
- borrowing costs were adjusted to align with group credit ratings and debt/equity position of the group after the business combination.

## US GAAP COMPARISON

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IFRS and US GAAP contain similar requirements for accounting for business combinations. However, IFRS and US GAAP differ with respect to certain business combination recognition and measurement requirements:

**Contingencies:** If the fair value of a contingent liability cannot be determined reliably, US GAAP requires that the contingency is recognized as an acquisition per ASC 450, *Contingencies*; IFRS requires that the contingency not be recognized. Also, IFRS does not permit the recognition of contingent assets acquired in a business combination whereas US GAAP requires recognition of contingent assets acquired at fair value.

**Combinations of entities under common control:** US GAAP requires that such combinations be accounted for under a carryover basis. IFRS does not provide guidance.

**Non-controlling interests:** US GAAP requires that non-controlling interests be measured at fair value. IFRS give entities the option, on a transaction-by-transaction basis, to measure non-controlling interests at fair value or at the non-controlling interest’s proportionate share of the fair value of the identifiable net assets, exclusive of goodwill.

**Goodwill:** Like IFRS, under US GAAP goodwill is recognized only upon the acquisition of a business and is not amortized but tested annually for impairment. Because goodwill is pushed down under IFRS to an operating segment or one level below (cash-generating units are not recognized under US GAAP), the grouping of cash flows used to test for impairment is almost always larger for US GAAP.

**Measurement period adjustments:** US GAAP requires measurement period adjustments to be made in the current reporting period rather than by adjusting the comparatives. (ASC 805-25-10-17)

the future liquidity and the net solvency of the entity as determined on a market value basis; in such instances, IFRS-basis financial statements will not provide information needed for making such determination.

A major objective of the accounting for shareholders' equity is the adequate disclosure of the sources from which the capital was derived. For this reason, a number of different contributed capital accounts may be presented in the statement of financial position. The rights of each class of shareholder must also be disclosed. Where shares are reserved for future issuance, such as under the terms of share option plans, this fact must also be made known. Share option plans will be addressed within Chapter 17.

A special situation arises in connection with cooperatives, which are member-owned organizations having capital which exhibits certain characteristics of debt, since it is not permanent in nature. IFRIC 2 addresses the accounting for members' shares in cooperatives. It holds that where a member of a cooperative has a contractual right to request redemption of shares, this does not necessarily require the shares to be classified as a liability. Members' shares are to be classified as equity if the entity has an unconditional right to refuse redemption, or if national law prohibits redemption. On the other hand, if the law prohibits redemption only conditionally (for example, if minimum capital requirements are not maintained), this does not alter the general rule that cooperative shares are to be deemed a liability, not equity, of the entity.

<i>IAS 1, 8, 32</i>	<b>Sources of IFRS</b>	<i>IFRIC 2</i>
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## DEFINITIONS OF TERMS

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**Equity instrument.** A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities, where liabilities are defined as the present obligations of the entity arising from past events, the settlement of which is expected to result in an out-flow from the entity of resources embodying economic benefits (i.e., an outflow of cash or other assets of the entity).

**Equity instrument granted.** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

**Equity-settled share-based payment transaction.** A share-based payment transaction in which the entity receives goods or services:

1. As consideration for its own equity instruments (including shares or share options); or
2. Where it has no obligation to settle the transaction with the supplier.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Measurement date.** The date at which the fair value of the equity instruments granted is measured for the purposes of this IFRS. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

**Puttable financial instruments.** Shares which the holders can “put” (sell) back to the issuing entity; that is, the holders can require that the entity repurchases the shares at defined amounts that can include fair value.

## RECOGNITION AND MEASUREMENT

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The IASB defines equity as the resulting net difference between total assets and total liabilities. Therefore no recognition requirements for equity have been included in the IFRSs.

The IASB has dealt primarily with presentation and disclosure requirements relating to shareholders' equity and are yet to fully address and resolve matters pertaining to the recognition and measurement of the various components of shareholders' equity. The issuance of IFRS 2, which thoroughly addresses the accounting for share-based payments, was a major step forward in this respect. It should be noted that in many jurisdictions, company law sets out specific requirements as regards accounting for equity, which may limit the application of IFRS.

IFRS does not always address all particular scenarios that may exist in practice, and in light of this, it provides in IAS 8 that in the absence of a standard, the preparer should refer to the *Framework* and thereafter to national GAAP based on the same conceptual framework. In the light of the project between the IASB and the FASB to converge IFRS and US GAAP, it is certainly possible that IFRS may formally adopt at least some of the US GAAP guidance, rather than attempt to create unique IFRS to deal with these matters. In the following discussion, therefore, certain guidance under US GAAP will be invoked where IFRS is silent regarding the accounting for specific types of transactions involving the entity's shareholders' equity. Since this is a rapidly evolving area, care should be taken to verify the current status of relevant developments.

## PRESENTATION AND DISCLOSURE

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Equity includes reserves such as statutory or legal reserves, general reserves and contingency reserves, and revaluation surplus. IAS 1 categorizes shareholders' interests in three broad subdivisions:

- Issued share capital;
- Retained earnings (accumulated profits or losses); and
- Other components of equity (reserves).

This standard also sets forth requirements for disclosures about the details of share capital for corporations and of the various capital accounts of other types of entities.

### Types of Shares

Ownership interest in an entity is made up of ordinary (common) shares and, optionally, preferred (preference) shares. The ordinary shares represent the residual risk-taking ownership of the corporation after the satisfaction of all claims of creditors and senior classes of equity. It is important that the actual common ownership be accurately identified, since the computation of earnings per share (described within Chapter 27) requires that the ultimate residual ownership class be properly associated with that calculation, regardless of what the various equity classes are nominally called.

Preferred shareholders are owners who have certain rights that are superior to those of common shareholders. These rights will pertain either to the earnings or the assets of the entity. Preferences as to earnings exist when the preferred shareholders have a stipulated dividend rate (expressed either as a dollar amount or as a percentage of the preferred share's par or stated value). Preferences as to assets exist when the preferred shares have a stipulated

liquidation value. If a corporation were to liquidate, the preferred holders would be paid a specific amount before the ordinary shareholders would have a right to participate in any of the proceeds.

In practice, preferred shares are more likely to have preferences as to earnings than as to assets. Some classes of preferred shares may have both preferential rights, although this is rarely encountered. Preferred shares may also have the following features:

- Participation in earnings beyond the stipulated dividend rate;
- A cumulative feature, affording the preferred shareholders the protection that their dividends in arrears, if any, will be fully satisfied before the ordinary shareholders participate in any earnings distribution; and
- Convertibility or callability by the entity.

Whatever preferences exist must be disclosed adequately in the financial statements, either in the statement of financial position or in the notes.

In exchange for the preferences, the preferred shareholders' rights or privileges are limited. For instance, the right to vote may be limited to ordinary shareholders. The most important right denied to the preferred shareholders, however, is the right to participate without limitation in the earnings of the corporation. Thus, if the corporation has exceedingly large earnings for a particular period, these earnings would accrue to the benefit of the ordinary shareholders. This is true even if the preferred shares are participating (itself a fairly uncommon feature) because even participating preferred shares usually have some upper limitation placed on the degree of participation. For example, preferred shares may have a 5% cumulative dividend with a further 3% participation right, so in any one year the limit would be an 8% return to the preferred shareholders (plus, if applicable, the 5% per year prior year dividends not paid).

Occasionally, as discussed in the chapter, several classes of share capital will be categorized as ordinary (e.g., Class A ordinary, Class B ordinary, etc.). Since there can be only one class of shares that constitutes the true residual risk-taking equity interest in a corporation, it is clear that the other classes, even though described as ordinary shares, must in fact have some preferential status. Not uncommonly, these preferences relate to voting rights, as when a control group holds ordinary shares with "super voting" rights (e.g., 10 votes per share). The rights and responsibilities of each class of shareholder, even if described as ordinary, must be fully disclosed in the financial statements.

### **Presentation and Disclosures Relating to Share Capital**

*The number or amount of shares authorized, issued, and outstanding.* It is required that a company disclose information relating to the number of shares authorized, issued and outstanding. Authorized share capital is defined as the maximum number of shares that a company is permitted to issue, according to its articles of association, its charter or its bylaws. The number of shares issued and outstanding could vary, based on the fact that a company could have acquired its own shares and is holding them as treasury shares (discussed below under reacquired shares).

*Capital not yet paid in (or unpaid capital).* In an initial public offering (IPO), subscribers may be asked initially to pay in only a portion of the par value, with the balance due in instalments, which are known as calls. Thus, it is possible that at the end of the reporting period a certain portion of the share capital has not yet been paid in. The amount not yet collected must be shown as a contra (i.e., a deduction) in the equity section, since that portion

of the subscribed capital has yet to be issued. For example, while the gross amount of the share subscription increases capital, if the due date of the final call falls on February 7, 20XX+1, following the accounting year-end of December 31, 20XX, the amount of capital not yet paid in should be shown as a deduction from shareholders' equity. In this manner, only the net amount of capital received as of the end of the reporting period will be properly included in shareholders' equity, averting an overstatement of the entity's actual equity.

IAS 1 requires that a distinction be made between shares that have been issued and fully paid, on the one hand, and those that have been issued but not fully paid, on the other hand. The number of shares outstanding at the beginning and at the end of each period presented must also be reconciled.

*Par value per share.* This is also generally referred to as legal value or face value per share. The par value of shares is specified in the corporate charter or bylaws and referred to in other documents, such as the share application and prospectus. Par value is the smallest unit of share capital that can be acquired unless the prospectus permits fractional shares (which is very unusual for commercial entities). In certain jurisdictions, it is also permitted for corporations to issue no-par shares (i.e., shares that are not given any par value). In such cases, again depending on local corporation laws, sometimes a stated value is determined by the board of directors, which is then accorded effectively the same treatment as par value. IAS 1 requires disclosure of par values or of the fact that the shares were issued without par values.

Historically, companies often issued shares at par value in cases where shares are issued immediately on incorporation or soon thereafter. This was partially due to laws, now rare, holding share owners contingently liable in the event of business failure, up to the amount of any discount from par value at the original issuance of shares. The prohibition against issuing shares at discount was thought to protect creditors and others, who could rely on aggregate par value as having been contributed in cash to the entity. It did not restrict any subsequent sale of the shares, however. As a practical matter, par values have had a much diminished importance as corporation laws have been modernized in many jurisdictions. Additionally, often the par values will be made trivial, such as when set at €1 or even €0.01 per share, such that the concern over an original-issuance discount is made moot, since issuance prices even at inception of a new corporation will be substantially above par value.

*Movements in share capital accounts during the year.* This information is usually disclosed in the financial statements or the footnotes to the financial statements, generally in a tabular or statement format, although in some circumstances merely set forth in a narrative. If a statement is presented, it is generally referred to as the Statement of Changes in Shareholders' Equity. It highlights the changes during the year in the various components of shareholders' equity. It also serves the purpose of reconciling the beginning and the ending balances of shareholders' equity, as shown in the statements of financial position. Under the provisions of revised IAS 1, reporting entities must present a statement showing that changes in all the equity accounts (including issued capital, retained earnings and reserves transactions with owners) are reported in this statement, while all changes other than those resulting from transactions with owners are to be reported in the statement of comprehensive income.

*Rights, preferences and restrictions with respect to the distribution of dividends and to the repayment of capital.* When there is more than one class of share capital having varying rights, adequate disclosure of the rights, preferences and restrictions attached to each such class of share capital will enhance understandability of the information provided by the financial statements.

*Cumulative preference dividends in arrears.* If an entity has preferred shares outstanding, and does not pay cumulative dividends on the preference shares annually when due, it will be required by statute to pay such arrears in later years, before any distributions can be made on common (ordinary) shares. When there are several series of preferred shares, the individual share indentures will spell out the relative preference order, so that, for example, senior preferred series may be paid dividends even though junior preferred shares are several years in arrears. Although practice varies, most preference shares are cumulative in nature. Preference shares that do not have this feature are called non-cumulative preference shares.

*Treasury shares.* Shares that are issued but then reacquired by a company are referred to as treasury shares. The entity's ability to reacquire shares may be limited by its corporate charter or by covenants in its loan and/or preferred share agreements (for example, it may be restricted from doing so as long as bonded debt remains outstanding). In those jurisdictions where the company law permits the repurchase of shares, such shares, on acquisition by the company or its consolidated subsidiary, become legally available for reissue or resale without further authorization. Shares outstanding refers to shares other than those held as treasury shares. That is, treasury shares do not reduce the number of shares issued, but affect the number of shares outstanding. It is to be noted that certain countries prohibit companies from purchasing their own shares, since to do so is considered as a reduction of share capital that can be achieved only with the express consent of the shareholders in an extraordinary general meeting, and then only under certain defined conditions.

IAS 1 requires that shares in the entity held in its treasury or by its subsidiaries be identified for each category of share capital and be deducted from contributed capital. IAS 32 states that the treasury share acquisition transaction is to be reported in the statement of changes in equity. When later resold, any difference between acquisition cost and ultimate proceeds represents a change in equity, and is therefore not to be considered a gain or loss to be reported in the statement of comprehensive income. Accounting for treasury shares is discussed in further detail later in this chapter.

IAS 32 also specifies that the costs associated with equity transactions are to be accounted for as reductions of equity if the corresponding transaction was a share issuance, or as increases in the contra equity account when incurred in connection with treasury share reacquisitions. Relevant costs are limited to incremental costs directly associated with the transactions. If the issuance involves a compound instrument, the issuance costs should be associated with the liability and equity components, respectively, using a rational and consistent basis of allocation.

*Shares reserved for future issuance under options and sales contracts, including the terms and amounts.* Companies may issue share options that grant the holder of these options rights to a specified number of shares at a certain price. Share options have become a popular means of employee remuneration, and often the top echelon of management is offered this non-cash perquisite as a major part of their remuneration packages. The options grant the holder the right to acquire shares over a defined time horizon for a fixed price, which may equal fair value at the grant date or, less commonly, at a price lower than fair value. Granting options usually is not legal unless the entity has enough authorized but unissued shares to satisfy the holders' demands, if made, although in some instances this can be done, with management thus becoming bound to the reacquisition of enough shares in the market (or by other means) to enable it to honour these new commitments. If a company has shares reserved for future issuance under option plans or sales contracts, it is necessary to disclose the number of shares, including terms and amounts, so reserved. These reserved shares are not available for sale or distribution to others during the terms of the unexercised options.



IAS 32 deals with situations in which entity obligations are to be settled in cash or in equity securities, depending on the outcome of contingencies not under the issuer's control. In general, these should be classed as liabilities, unless the part that could require settlement in cash is not genuine, or settlement by cash or distribution of other assets is available only in the event of the liquidation of the issuer. If the option holder can demand cash, the obligation is a liability, not equity.

The accounting for share options, which was introduced by IFRS 2, is dealt within Chapter 17. As will be seen, it presents many intriguing and complex issues.

### **Presentation and Disclosures Relating to Other Equity**

*Capital contributed in excess of par value.* This is the amount received on the issuance of shares that is the excess over the par value. It is called "additional contributed capital" in the United States, while in many other jurisdictions, it is referred to as "share premium." Essentially the same accounting would be required if a stated value is used in lieu of par value, where permitted.

*Revaluation reserve.* When a company carries property, plant and equipment or intangible assets under the revaluation model, as is permitted by IAS 16 and IAS 38 (revaluation to fair value), the difference between the cost (net of accumulated depreciation) and the fair value is recognized in other comprehensive income and accumulated in equity as the Revaluation Surplus.

IAS 1 requires that movements of this reserve during the reporting period (year or interim period) be disclosed in the other comprehensive income section of the statement of comprehensive income. Increases in an asset's carrying value are recognized in other comprehensive income and accumulated in equity. Decreases are recognized in other comprehensive income only to the extent of any credit balance existing in the revaluation surplus in respect of that asset, and additional decreases are taken to profit or loss. Also, restrictions as to any distributions of this reserve to shareholders should be disclosed. Note that in some jurisdictions the directors may be empowered to make distributions in excess of recorded book capital, and this often will require a determination of fair values.

*Reserves.* Reserves include capital reserves as well as revenue reserves. Also, statutory reserves and voluntary reserves are included under this category. Finally, special reserves, including contingency reserves, are included herein. The use of general reserves and statutory reserves, once common or even required under company laws in many jurisdictions, is now in decline.

Statutory reserves (or legal reserves, as they are called in some jurisdictions) are created based on the requirements of the law or the statute under which the company is incorporated. For instance, many corporate statutes in Middle Eastern countries require that companies set aside 10% of their net income for the year as a "statutory reserve," with such appropriations to continue until the balance in this reserve account equals 50% of the company's equity capital. The intent is to provide an extra "cushion" of protection to creditors, such that even significant losses incurred in later periods will not reduce the entity's actual net worth below zero, which would, were it to occur, threaten creditors' ability for repayment of liabilities.

Sometimes a company's articles, charter or bylaws may require that each year the company set aside a certain percentage of its net profit (income) by way of a contingency or general reserve. Unlike statutory or legal reserves, contingency reserves are based on the provisions of corporate bylaws. The use of general reserves is not consistent with IFRS.

The standard requires that movements in these reserves during the reporting period be disclosed, along with the nature and purpose of each reserve presented within owners' equity.

*Retained earnings.* By definition, retained earnings represent an entity's accumulated profits (or losses) less any distributions that have been made therefrom. However, based on provisions contained in IFRS, other adjustments are also made to the amount of retained earnings. IAS 8 requires the following to be shown as adjustments to retained earnings:

- a. Correction of accounting errors that relate to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.
- b. The adjustment resulting from a change in accounting policy that is to be applied retrospectively should be reported as an adjustment to the opening balance of retained earnings. Comparative information should be restated unless it is impracticable to do so.

When dividends have been proposed but not formally approved, and hence when such intended dividends have not yet become reportable as a liability of the entity, disclosure is required by IAS 1. Dividends declared after the end of the reporting period, but prior to the issuance of the financial statements, must be disclosed but cannot be formally recognized via a charge against retained earnings (as was sometimes done in the past, and as remains normal practice in certain jurisdictions under national rules). Also, the amount of any cumulative preference dividends not recognized as charges against accumulated profits must be disclosed (i.e., arrears), either parenthetically or in the footnotes.

IAS 1 mandates that an entity should present in a statement of changes in equity the amount of total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent (controlling interest) and to the non-controlling interest. Comprehensive income includes all components of what was formerly denoted as "profit or loss" and of "other recognized income and expense." The latter category will henceforth be known as "other comprehensive income."

The components of other comprehensive income comprise:

1. Changes in revaluation surplus (see IAS 16, *Property, Plant and Equipment*, and IAS 38, *Intangible Assets*);
2. Gains and losses arising from translating the financial statements of a foreign operation (see IAS 21, *The Effects of Changes in Foreign Exchange Rates*);
3. Gains and losses on remeasuring available-for-sale financial assets (see IAS 39, *Financial Instruments: Recognition and Measurement*);
4. The effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39 or IFRS 9 if adopted); and
5. Actuarial gains and losses on defined benefit plans recognized in accordance with IAS 19, *Employee Benefits*.

This topic is covered in more detail in a separate discussion within Chapter 5.

## **CLASSIFICATION BETWEEN LIABILITIES AND EQUITY**

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A longstanding challenge under IFRS has been to discern between instruments that are liabilities and those that truly represent permanent equity in an entity. This has been made more difficult as various hybrid instruments have been created over recent decades. IAS 32 requires that the issuer of a financial instrument should classify the instrument, or its components, as a liability or as equity, according to the substance of the contractual arrangement on initial recognition.

The standard defines a financial liability as a contractual obligation:

1. To deliver cash or another financial asset to another entity; or
2. To exchange financial instruments with another entity under conditions that are potentially unfavourable.

An equity instrument, on the other hand, has been defined by the standard as any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities.

A special situation arises in connection with cooperatives, which are member-owned organizations having capital which exhibits certain characteristics of debt, since it is not permanent in nature. IFRIC 2 addresses the accounting for members' shares in cooperatives. This is further elaborated in the paragraph "Members' Shares in Cooperative Entities."

IASB also considered the special case of shares which are puttable to the entity for a proportion of the fair value of the entity. Under then-existing IFRS, when this right was held by the shareholder, redemption could be demanded, and accordingly the shares were to be classified as a liability and to be measured at fair value. This created what was viewed by many as an anomalous situation whereby a successful entity using historical cost would have a liability that increases every year and leaves the reporting entity with, potentially, no equity at all in its statement of financial position. The logic was that, since the equity in the business would not be truly permanent in nature, and would represent a claim on the assets of the entity, it would not be properly displayed as a liability—although clearly this must be adequately explained to users of the financial statements.

In responding to the foregoing concern, the IASB issued the Amendment to IAS 32, "Financial Instruments: Presentation," and IAS 1, "Presentation of Financial Statements, Puttable Financial Instruments and Obligations Arising on Liquidation," which requires that financial instruments that are puttable at fair value, as well as obligations to deliver to another entity a pro rata share of the net assets of the entity upon its liquidation, should be classified as equity. Under prior practice these instruments were classified as financial liabilities.

### ***Puttable shares***

Certain puttable shares, which were classified as liabilities in the statement of financial position under a previous version of IAS 32, are now required to be presented as equity if strict conditions are met. The purpose is to avoid anomalous results when residual equity interests, which would be entitled to a pro rata share of the entity's net assets upon liquidation, are puttable throughout the life of the entity at fair value.

The conditions that must be met should limit the application of this exception to the general, and fundamental rule that instruments that obligate the entity to the payment of cash must be reported as liabilities. The conditions are that:

- The instrument's holders are entitled to their pro rata share of the entity's net assets upon the liquidation of the entity.
- The instrument is in the class of instruments that is most subordinate (i.e., is among the residual equity interests in the entity) and all instruments in that class have identical features.
- The instrument has no other features that would require classification as a liability.
- The total expected cash flows attributable to the instrument, over its life, are based substantially on profit or loss, or change in recognized net assets, or change in the fair

value of recognized or unrecognized net assets; there must be no other instruments outstanding that have equivalent terms that would effectively restrict or fix the residual returns to these instrument holders.

This results in equity classification of puttable shares having the foregoing characteristics, whether the shares are puttable throughout the instrument's life at fair value or only upon liquidation. Puttable instruments not meeting the criteria must be presented as liabilities.

IAS 1 requires the following expanded disclosures in circumstances when puttable instruments are included in equity. These disclosures include:

- Summary quantitative data about the amount classified as equity;
- The entity's objectives, policies and processes for managing the obligation to repurchase or redeem such instruments, including changes therein;
- The expected cash outflow on redemption or repurchase; and
- Information on the means of determining such cash outflows.

### ***Compound financial instruments***

Increasingly, entities issue financial instruments that exhibit attributes of both equity and liabilities. IAS 32 stipulates that an entity that issues such financial instruments, which are technically known as compound instruments, should classify the component parts of the financial instrument separately as equity or liability as appropriate. (For a detailed discussion on financial instruments, refer to Chapter 24.) In terms of IAS 32, the full fair value of the liability component(s) must be reported as liabilities, and only the residual value, at issuance, should be included as equity.

## **SHARE ISSUANCES AND RELATED MATTERS**

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### **Additional Guidance Relative to Share Issuances and Related Matters**

As noted, IFRS provides only minimal guidance regarding the actual accounting for share-based transactions, including the issuance of shares of various classes of equity instruments. In the following paragraphs, suggestions are made concerning the accounting for such transactions, which are within the spirit of IFRS, although largely drawn from other authoritative sources. This is done to provide guidance which conforms to the requirements under IAS 8 (hierarchy of professional standards), and to illustrate a wide array of actual transactions that often need to be accounted for.

### ***Accounting for the issuance of shares***

The accounting for the sale of shares by a corporation depends on whether the share capital has a par or stated value. If there is a par or stated value, the amount of the proceeds representing the aggregate par or stated value is credited to the ordinary or preferred share capital account. The aggregate par or stated value is generally defined as legal capital not subject to distribution to shareholders. Proceeds in excess of par or stated value are credited to an additional contributed capital account. The additional contributed capital represents the amount in excess of the legal capital that may, under certain defined conditions, be distributed to shareholders. A corporation selling shares below par value credits the share capital account for the par value and debits an offsetting discount account for the difference between par value and the amount actually received.

If there is a discount on original issue of share capital, it serves to notify the actual and potential creditors of the contingent liability of those investors. As a practical matter, corporations avoided this problem by reducing par values to an arbitrarily low amount. This reduction in par eliminated the chance that shares would be sold for amounts below par. Where corporation laws make no distinction between par value and amounts in excess of par, the entire proceeds from the sale of shares may be credited to the ordinary share capital account without distinction between the share capital and the additional contributed capital accounts. The following entries illustrate these concepts:

Facts:	A corporation sells 100,000 shares of €5 par ordinary share for €8 per share cash.		
	Cash	800,000	
	Ordinary share capital		500,000
	Additional contributed capital/share premium		300,000
Facts:	A corporation sells 100,000 shares of no-par ordinary share for €8 per share cash.		
	Cash	800,000	
	Ordinary share capital		800,000

Preferred shares will often be assigned a par value because in many cases the preferential dividend rate is defined as a percentage of par value (e.g., 5%, €25 par value preferred share will have a required annual dividend of €1.25). The dividend can also be defined as a euro amount per year, thereby obviating the need for par values.

#### ***Share capital issued for services***

If the shares in a corporation are issued in exchange for services or property rather than for cash, the transaction should be reflected at the fair value of the property or services received. If this information is not readily available, the transaction should be recorded at the fair value of the shares that were issued. Where necessary, appraisals should be obtained to properly reflect the transaction. As a final resort, a valuation by the board of directors of the shares issued can be utilized. Shares issued to employees as compensation for services rendered should be accounted for at the fair value of the shares issued. (See discussion of IFRS 2 within Chapter 17.)

Occasionally, particularly for start-up operations having limited working capital, the controlling owners may directly compensate certain vendors or employees. If shares are given by a major shareholder directly to an employee for services performed for the entity, this exchange should be accounted for as a capital contribution to the company by the major shareholder and as compensation expense incurred by the company. Only when accounted for in this manner will there be conformity with the general principle that all costs incurred by an entity, including compensation, should be reflected in its financial statements.

#### ***Issuance of share units***

In certain instances, ordinary and preferred shares may be issued to investors as a unit (e.g., a unit of one share of preferred and two ordinary shares can be sold as a package). Where both of the classes of shares are publicly traded, the proceeds from a unit offering should be allocated in proportion to the relative market values of the securities. If only one of the securities is publicly traded, the proceeds should be allocated to the one that is publicly traded based on its known market value. Any excess is allocated to the other. Where the market value of neither security is known, appraisal information might be used. The imputed

fair value of one class of security, particularly the preferred shares, can be based on the stipulated dividend rate. In this case, the amount of proceeds remaining after the imputing of a value of the preferred shares would be allocated to the ordinary shares.

The foregoing procedures would also apply if a unit offering were made of an equity and a non-equity security such as convertible debentures, or of shares and rights to purchase additional shares for a fixed time period.

### *Share subscriptions*

Occasionally, particularly in the case of a newly organized corporation, a contract is entered into between the corporation and prospective investors, whereby the latter agree to purchase specified numbers of shares to be paid for over some instalment period. These share subscriptions are not the same as actual share issuances, and the accounting differs accordingly. In some cases, laws of the jurisdiction of incorporation will govern how subscriptions have to be accounted for (for example, when pro rata voting rights and dividend rights accompany partially paid subscriptions).

The amount of share subscriptions receivable by a corporation is sometimes treated as an asset in the statement of financial position and is categorized as current or non-current in accordance with the terms of payment. However, most subscriptions receivable are shown as a reduction of shareholders' equity in the same manner as treasury shares. Since subscribed shares do not have the rights and responsibilities of actual outstanding shares, the credit is made to a shares subscribed account instead of to the share capital accounts.

If the ordinary shares have par or stated value, the ordinary shares subscribed account are credited for the aggregate par or stated value of the shares subscribed. The excess over this amount is credited to additional contributed capital or share premium. No distinction is made between additional contributed capital relating to shares already issued and shares subscribed for. This treatment follows from the distinction between legal capital and additional contributed capital. Where there is no par or stated value, the entire amount of the ordinary share subscribed is credited to the shares subscribed account.

As the amount due from the prospective shareholders is collected, the share subscriptions receivable account is credited and the proceeds are debited to the cash account. Actual issuance of the shares, however, must await the complete payment of the share subscription. Accordingly, the debit to ordinary share subscribed is not made until the subscribed shares are fully paid for and the shares are issued.

The following journal entries illustrate these concepts:

1. 10,000 shares of €50 par preferred are subscribed at a price of €65 each; a 10% down payment is received.

Cash	65,000	
Share subscriptions receivable	585,000	
Preferred share subscribed		500,000
Additional contributed capital/share premium		150,000

2. 2,000 shares of no par ordinary shares are subscribed at a price of €85 each, with one-half received in cash.

Cash	85,000	
Share subscriptions receivable	85,000	
Ordinary share subscribed		170,000

3. All preferred subscriptions are paid, and one-half of the remaining ordinary subscriptions are collected in full and subscribed shares are issued.

Cash [ $€585,000 + (€85,000 \times 0.50)$ ]	627,500	
Shares subscriptions receivable		627,500
Preferred shares subscribed	500,000	
Preferred share		500,000
Ordinary shares subscribed	127,500	
Ordinary shares ( $€170,000 \times 0.75$ )		127,500

When the company experiences a default by the subscriber, the accounting will follow the provisions of the jurisdiction in which the entity is incorporated. In some of these, the subscriber is entitled to a proportionate number of shares based on the amount already paid on the subscriptions, sometimes reduced by the cost incurred by the entity in selling the remaining defaulted shares to other shareholders. In other jurisdictions, the subscriber forfeits the entire investment on default. In this case the amount already received is credited to an additional contributed capital account that describes its source.

#### *Distinguishing additional contributed capital from the par or stated value of the shares*

For largely historical reasons, entities sometimes issue share capital having par or stated value, which may be only a nominal value, such as €1 or even €0.01. The actual share issuance will be at a much higher (market driven) amount, and the excess of the issuance price over the par or stated value might be assigned to a separate equity account referred to as premium on capital (ordinary) shares or additional contributed (paid-in) capital. Generally, but not universally, the distinction between ordinary shares and additional contributed capital has little legal import, but may be maintained for financial reporting purposes nonetheless.

Additional contributed capital represents all capital contributed to an entity other than that defined as par or stated value. Additional contributed capital can arise from proceeds received from the sale of ordinary and preferred shares in excess of their par or stated values. It can also arise from transactions relating to the following:

1. Sale of shares previously issued and subsequently reacquired by the entity (treasury shares).
2. Retirement of previously outstanding shares.
3. Payment of share dividends in a manner that justifies the dividend being recorded at the market value of the shares distributed.
4. Lapse of share purchase warrants or the forfeiture of share subscriptions, if these result in the retaining by the entity of any partial proceeds received prior to forfeiture.
5. Warrants that are detachable from bonds.
6. Conversion of convertible bonds.
7. Other gains on the entity's own shares, such as that which results from certain share option plans.

When the amounts are material, the sources of additional contributed capital should be described in the financial statements.

Examples of various transactions giving rise to (or reducing) additional contributed capital accounts are set forth below.

<b>Examples of additional contributed capital transactions</b>
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Alta Vena Company issues 2,000 shares of ordinary shares having a par value of €1, for a total price of €8,000. The following entry records the transaction:

Cash	8,000	
Ordinary shares		2,000
Additional contributed capital		6,000

Alta Vena Company buys back 2,000 shares of its own ordinary share for €10,000 and then sells these shares to investors for €15,000. The following entries record the buyback and sale transactions, respectively:

Treasury shares	10,000	
Cash		10,000
Cash	15,000	
Treasury shares		10,000
Additional contributed capital		5,000

Alta Vena Company buys back 2,000 shares of its own €1 par value ordinary shares (which it had originally sold for €8,000) for €9,000 and retires the shares, which it records with the following entry:

Ordinary shares	6,000	
Additional contributed capital	2,000	
Retained earnings	1,000	
Cash		9,000

Alta Vena Company issues a small share dividend of 5,000 ordinary shares at the market price of €8 per share. Each share has a par value of €1. The following entry records the transaction:

Retained earnings	40,000	
Ordinary shares		5,000
Additional contributed capital		35,000

Alta Vena Company previously has recorded €1,000 of share options outstanding as part of a compensation agreement. The options expire a year later, resulting in the following entry:

Share options outstanding	1,000	
Retained earnings		1,000

Alta Vena's bondholders convert a €1,000 bond with an unamortized premium of €40 and a market value of €1,016 into 127 shares of €1 par ordinary share whose market value is €8 per share. This results in the following entry:

Bonds payable	1,000	
Premium on bonds payable	40	
Ordinary shares		913
Additional contributed capital—warrants		127

### ***Donated capital***

Donated capital can result from an outright gift to the entity (for example, a major shareholder donates land or other assets to the company in a non-reciprocal transfer) or may result when services are provided to the entity. Such a transaction may be treated as a capital



contribution in the books of the receiving entity as it is received from a shareholder, the argument being that it is a capital injection from the shareholder.

### **Compound and Convertible Equity Instruments**

Entities sometimes issue preferred shares which are convertible into ordinary shares. Where the preferred shares are non-redeemable, the accounting for both the preferred and ordinary shares is similar as they both represent equity in the issuer. The treatment of convertible preferred shares at its issuance is no different from that of non-convertible preferred shares. When it is converted, the book value approach is used to account for the conversion. Use of the market value approach would entail a gain or loss for which there is no theoretical justification, since the total amount of contributed capital does not change when the share capital is converted. When the preferred shares are converted, the "Preferred shares" and related "Additional contributed capital—preferred shares" accounts are debited for their original values when purchased, and "Ordinary shares" and "Additional contributed capital—ordinary shares" (if an excess over par or stated value exists) are credited. If the book value of the preferred shares is less than the total par value of the ordinary shares being issued, retained earnings is charged for the difference. This charge is supported by the rationale that the preferred shareholders are offered an additional return to facilitate their conversion to ordinary share. Some jurisdictions require that this excess instead reduce additional contributed capital from other sources.

On the other hand, the issuance of debt that is convertible into equity (almost always into ordinary shares) does trigger accounting complexities. Under IAS 32, it is necessary for the issuer of non-derivative financial instruments to ascertain whether it contains both liability and equity components. If the instrument does contain both elements (for example, debentures convertible into ordinary shares), these components must be separated and accounted for according to their respective natures.

In the case of convertible debt, the instrument is viewed as being constituted of both an unconditional promise to pay (a liability) and an option granting the holder the right, but not the obligation, to obtain the issuer's shares under a fixed conversion ratio arrangement. (Under provisions of IAS 32, unless the number of shares that can be obtained on conversion is fixed, the conversion option is not an equity instrument.) This option, at issuance date, is an equity instrument and must be accounted for as such by the issuer, whether subsequently exercised or not.

The amount allocated to equity is the residual derived by deducting the fair value of the liability component (typically, by discounting to present value the future principal and interest payments on the debt by the relevant interest rate) from the total proceeds of issuance. It would not be acceptable to derive the amount to be allocated to debt as a residual, on the other hand this is a conservative rule that effectively maximizes the allocation to debt and minimizes the allocation to equity.

### **Retained Earnings**

Accounting traditionally has clearly distinguished between equity contributed by owners (including donations from owners) and that resulting from the operating results of the reporting entity, consisting mainly of accumulated earnings since the entity's inception less amounts distributed to shareholders (i.e., dividends). Equity in each of these two categories is generically distinct from the other, and financial statement users need to be informed of the

composition of shareholders' equity so that, for example, the cumulative profitability of the entity can be accurately gauged.

Legal capital (the defined aggregate par or stated value of the issued shares), additional contributed capital and donated capital collectively represent the contributed capital of the entity. The other major source of capital is retained earnings, which represents the accumulated amount of earnings of the entity from the date of inception (or from the date of reorganization) less the cumulative amount of distributions made to shareholders and other charges to retained earnings (e.g., from treasury share transactions). The distributions to shareholders generally take the form of dividend payments, but may take other forms as well, such as the reacquisition of shares for amounts in excess of the original issuance proceeds. The key events impacting retained earnings are as follows:

- Dividends;
- Certain sales of shares held in the treasury at amounts below acquisition cost;
- Certain share retirements at amounts in excess of book value;
- Prior period adjustments;
- Recapitalizations and reorganizations.

#### Examples of retained earnings transactions

Baking Bread Co. declares a dividend of €84,000, which it records with the following entry:

Retained earnings	84,000	
Dividends payable		84,000

Baking Bread acquires 3,000 shares of its own €1 par value ordinary shares for €15,000 and then resells it for €12,000. The following entries record the buyback and sale transactions, respectively, assuming the use of the cost method of accounting for treasury shares:

Treasury shares	15,000	
Cash		15,000
Cash	12,000	
Retained earnings	3,000	
Treasury shares		15,000

Baking Bread buys back 12,000 shares of its own €1 par value ordinary shares (which it had originally sold for €60,000) for €70,000 and retires the shares, which it records with the following entry:

Ordinary shares	12,000	
Additional contributed capital	48,000	
Retained earnings	10,000	
Cash		70,000

Baking Bread's accountant makes a mathematical mistake in calculating depreciation, requiring a prior period reduction of €30,000 to the accumulated depreciation account, and corresponding increases in its income tax payable and retained earnings accounts. Baking Bread's income tax rate is 35%. It records this transaction with the following entry:

Accumulated depreciation	30,000	
Income taxes payable		10,500
Retained earnings		19,500

An important rule relating to retained earnings is that transactions in an entity's own shares can result in a reduction of retained earnings (i.e., a deficiency on such transactions can be charged to retained earnings) but cannot result in an increase in retained earnings (any excesses on such transactions are credited to contributed capital, never to retained earnings).

If a series of operating losses have been incurred or distributions to shareholders in excess of accumulated earnings have been made and if there is a debit balance in retained earnings, the account is generally referred to as accumulated deficit.

## **Dividends and Distributions**

### ***Cash dividends***

Dividends represent the pro rata distribution of earnings to the owners of the entity. The amount and the allocation between the preferred and ordinary shareholders is a function of the stipulated preferential dividend rate, the presence or absence of (1) a participation feature, (2) a cumulative feature, and (3) arrears on the preferred shares, and the wishes of the board of directors. Dividends, even preferred share dividends where a cumulative feature exists, do not accrue. Depending on the jurisdiction, one may find that dividends become a liability of the entity only when they are declared by the board of directors or when members vote to accept a dividend.

Traditionally, entities were not allowed to declare dividends in excess of the amount of retained earnings. Alternatively, an entity could pay dividends out of retained earnings and additional contributed capital but could not exceed the total of these categories (i.e., they could not impair legal capital by the payment of dividends). Local company law obviously dictates, directly or by implication, the accounting to be applied in many of these situations. For example, in some jurisdictions, entities can declare and pay dividends in excess of the book amount of retained earnings if the directors conclude that, after the payment of such dividends, the fair value of the entity's net assets will still be a positive amount. Thus, directors can declare dividends out of unrealized appreciation, which, in certain industries, can be a significant source of dividends beyond the realized and recognized accumulated earnings of the entity. This action, however, represents a major departure from traditional practice and demands both careful consideration and adequate disclosure.

Four important dividend dates are:

1. The declaration date;
2. The approval date;
3. The record date;
4. The payment date.

The declaration date or approval date (depending on the jurisdiction) governs the incurrence of a legal liability by the entity. The approval date is the date when the shareholders of the entity vote on whether or not to accept the dividend declared. This date governs the incurrence of a legal liability by the entity. In some jurisdictions, the applicable legislation stipulates that an entity does not incur an obligation to pay a dividend until such time as the shareholders vote to accept a dividend payment.

The record date refers to that point in time when a determination is made as to which specific registered shareholders will receive dividends and in what amounts.

Finally, the payment date relates to the date when the distribution of the dividend takes place.

These concepts are illustrated in the following example:

**Example of payment of dividends**

On April 1 the directors of River Corp. declare a €75 per share quarterly dividend on River Corp.'s 650,000 outstanding ordinary shares. The shareholder vote and approve the dividend on May 1. The dividend is payable May 25 to holders of record May 15.

May 1	Retained earnings (or Dividends)	487,500	
	Dividends payable		487,500
May 15	No entry passed		
May 25	Dividends payable	487,500	
	Cash		487,500

If a dividends account is used, it is closed directly to retained earnings at year-end.

Dividends may be made in the form of cash, property or scrip. Cash dividends are either a given dollar amount per share or a percentage of par or stated value. Property dividends consist of the distribution of any assets other than cash (e.g., inventory or equipment). Finally, scrip dividends are either promissory notes due at some time in the future, sometimes bearing interest until final payment is made; or are the issuance of additional shares made in lieu of a cash dividend. In such a scenario, shareholders are often able to choose whether to receive a cash dividend or shares in settlement of the dividend due to them.

Occasionally, what appear to be disproportionate dividend distributions are paid to some but not all of the owners of closely held entities. Such transactions need to be analysed carefully. In some cases these may actually represent compensation paid to the recipients. In other instances, these may be a true dividend paid to all shareholders on a pro rata basis, to which certain shareholders have waived their rights. If the former, the distribution should not be accounted for as a dividend but as compensation or some other expense category and included in the statement of comprehensive income. If the latter, the dividend should be grossed up to reflect payment on a proportional basis to all the shareholders, with an offsetting capital contribution to the company recognized as having been effectively made by those to whom payments were not made.

Upon occasion, dividends may be paid in property other than cash. For example, a merchandising firm may distribute merchandise to shareholders in lieu of cash, although this makes it more difficult to assure absolute proportionality. When, say, inventory is used to distribute earnings to shareholders, the accounting is similar to that shown above, except inventory is credited rather than cash. IFRIC 17, *Distributions of Non-cash Assets to Owners*, addresses the accounting relating to the distribution of such assets to shareholders. IFRIC 17 works on the assumption that the fair value of the assets to be distributed can be determined and it is on this basis that the accounting then follows. For example, if inventory carried at a cost of \$100,000, and having a fair value of \$125,000, is distributed to shareholders as a dividend, the entity would record profit of \$25,000 on realization of the inventory and a dividend payment of \$125,000.

**Liquidating dividends**

Liquidating dividends are not distributions of earnings, but rather, a return of capital to the investing shareholders. A liquidating dividend is normally recorded by the declarer through charging additional contributed capital rather than retained earnings. The exact

accounting for a liquidating dividend is affected by the laws where the business is incorporated, and these laws vary among jurisdictions. There will often be tax implications of liquidating dividend payments, which must also be considered.

### ***Taxation impact***

Any income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction should be accounted for in accordance with IAS 12, *Income Taxes* (See Chapter 26). In practice, the amendment was clarifying that if there are tax consequences, such as a secondary tax on companies or a withholding tax on distributions, then these should be accounted for under IAS 12 and not as part of the equity distribution. In most jurisdictions, this is how entities had been applying these requirements, so the amendment is not expected to have a major impact.

### **Accounting for Treasury Share Transactions**

The term treasury share refers to the entity's shares that were issued but subsequently reacquired and are being held ("in the company's treasury") without having been canceled. An entity may buy back its own shares, subject to laws of the jurisdiction of incorporation, for possibly many different and legitimate business purposes, such as to have on hand for later share-based payments to employees or vendors, or to decrease the "float" of shares outstanding—which may be done to provide upward pressure on the quoted price of the share or increase the earnings per share by decreasing the number of outstanding shares.

IFRS addresses treasury shares and sets as a general principle that "earnings" cannot be created by transactions in an entity's own shares, and thus the proper accounting would be to report these as capital transactions only.

Treasury shares do not reduce the number of shares issued but do reduce the number of shares outstanding, as well as total shareholders' equity. These shares are not eligible to receive cash dividends. Treasury shares are not an asset. Reacquired shares that are awaiting delivery to satisfy a liability created by the firm's compensation plan or reacquired shares that are held in a profit-sharing trust may still be considered outstanding and, thus, may not be considered treasury shares. The terms and conditions of the compensation plan would need to be considered in the light of IFRS10, *Consolidated Financial Statements*, which is addressed within Chapter 15.

### **Members' Shares in Cooperative Entities**

Certain organizations are so-called membership organizations or cooperatives. These are often entities providing services to a group having common membership or interests, such as labour unions or university faculty and staff. Credit unions (a form of savings and loan association) are a common example of this form of organization. Other cooperatives may serve as marketing vehicles, as in the case of farmers' co-ops, or as buying organizations, as in co-operatives formed by merchants in certain types of businesses, generally in order to gain economies of scale and market power in order to compete with larger merchant chains. Generally, these types of organizations will refund or rebate profits to the members in proportion to the amount of business transacted over a time period, such as a year.

Ownership in cooperatives is represented by shares. Members' shares in cooperative entities have some characteristics of equity, but also, often, characteristics of debt, since they are not permanent equity which cannot be withdrawn. Members' shares typically give the

holder the right to request redemption for cash, although that right may be subject to certain limitations or restrictions, imposed by law or by the terms of the membership agreement. IFRIC 2, *Members' Shares in Cooperative Entities and Similar Instruments*, gives guidance on how those redemption terms should be evaluated in determining whether the shares should be classified as financial liabilities or as equity.

Under IFRIC 2, shares for which the member has the right to request redemption are normally liabilities. Even when the intent is to leave in the equity interest for a long period, such as until the member ceases business operations, this does not qualify as true equity as defined in the *Framework*. However, the shares qualify as equity if:

- The cooperative entity has an unconditional right to refuse redemption; or
- Local law, regulation, or the entity's governing charter imposes prohibitions on redemption.

However, the mere existence of law, regulation or charter provisions that would prohibit redemption only if conditions (such as liquidity constraints) are met, or are not met, does not result in members' shares being treated as equity.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

### 26. Share capital and reserves

#### 26.1 Ordinary shares

	<b>20XX</b>	<b>20XX-1</b>
Authorized	<u>X</u>	<u>X</u>
X million ordinary shares of £ X each	X	X
Issued and fully paid for	<u>X</u>	<u>X</u>
X million ordinary shares of £ X each	X	X
Reconciliation of the number of shares outstanding		
Opening balance	X	X
Shares issued	X	X
Shares repurchased	<u>X</u>	<u>X</u>
Closing balance	<u>X</u>	<u>X</u>

All fully paid up shares have a par value of £x and entitle the holder to one vote and equal rights to dividends declared.

#### 26.2 Disclosure of components of other comprehensive income

The available for sale movement in other comprehensive income comprises arising gains recognized during the year of £X (20XX-1: £X) less amounts recycled through profit or loss of £X (20XX-1: £X).

## 26.3 Disclosure of tax effects relating to each component of other comprehensive income

	20XX			20XX-1		
	Before tax amount	Tax (expense) / benefit	Net-of-tax amount	Before tax amount	Tax (expense) / benefit	Net-of-tax amount
Exchange differences in translating foreign operations	X	X	X	X	X	X
Available-for-sale financial assets	X	X	X	X	X	X
Actuarial gains or losses on defined benefit pension plan	X	X	X	X	X	X
Share of other comprehensive income of associates	X	X	X	X	X	X
Other comprehensive income	X	X	X	X	X	X

**COMPARISON WITH US GAAP**

There are differences in terminology between IFRS and US GAAP. For example, US GAAP does not use the terms “reserve” or “surplus.” US GAAP uses the Accumulated Other Comprehensive Income account. IFRS reports “revaluation surplus” for increases or decreases property, plant and equipment, mineral resources, intangible assets, etc. US GAAP does not report unrealized gains on those items in the financial statements.

Preference shares under US GAAP are presented in equity and not with liabilities.

## SCOPE

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IFRS 2 applies to the accounting for *all* share-based payment transactions, including:

- Equity-settled share-based payment transactions;
- Cash-settled share-based payment transactions; and
- Cash-settled *or* equity-settled share-based payment transactions (when the entity has a choice to settle the transaction in cash (or other assets) or by issuing equity instruments).

This standard may also apply in the absence of specifically identifiable goods and services but when other circumstances indicate that goods or services have been (or will be) received.

Furthermore—and very importantly—IFRS 2 applies to all entities (both publicly and privately held). Also, a subsidiary using its parent's or other subsidiary's equity as consideration for goods or services is within the scope of this standard. However, an entity should *not* apply this IFRS to transactions in which the entity acquires goods as part of the net assets acquired in a business combination (transactions within the scope of IFRS 3). In such cases, it is important to distinguish share-based payments related to the acquisition from those related to employee services. Also, IFRS 2 does not apply to share-based payment contracts within the scope of IAS 32 and IAS 39.

IFRS 2 has been amended in 2013 to provide for changes to the definition of vesting condition and market condition and also brought in separate definition for 'performance condition' and 'service condition'. Consequently, it has been clarified that such changes to definitions be applied for grant dates on or after July 1, 2014, while earlier application is recommended.

## DEFINITIONS OF TERMS

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**Cash-settled share-based payment transaction.** A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or shares options) of the entity or another group entity.

**Employees and others providing similar services.** Individuals who render personal services to the entity and meet one of the following additional criteria:

1. The individuals are regarded as employees for legal or tax purposes;
2. The individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes; or
3. The services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel (i.e., those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors).

**Equity instrument.** A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities, where liabilities are defined as the present obligations of the entity arising from past events, the settlement of which is expected to result in an out-flow from the entity of resources embodying economic benefits (i.e., an outflow of cash or other assets of the entity).



**Equity instrument granted.** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

**Equity-settled share-based payment transaction.** A share-based payment transaction in which the entity receives goods or services either:

1. As consideration for its own equity instruments (including shares or share options); or
2. Where it has no obligation to settle the transaction with the supplier.

**Grant date.** The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

**Intrinsic value.** The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares.

**Market condition.** A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group) relative to an index of market prices of equity instruments of other entities. A market condition requires the counterparty to complete a specified period of service (i.e. a service condition); the service requirement can be explicit or implicit.

**Measurement date.** The date at which the fair value of the equity instruments granted is measured for the purposes of this IFRS. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

**Performance condition.** A vesting condition that requires:

- (a) The counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit; and
- (b) Specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):

- (a) Shall not extend beyond the end of the service period; and
- (b) May start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

A performance target is defined by reference to:

- (a) The entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e., a non-market condition); or
- (b) The price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (i.e., a market condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

**Puttable financial instruments.** Shares which the holders can “put” back to the issuing entity; that is, the holders can require that the entity repurchases the shares, at defined amounts that can include fair value.

**Reload feature.** A feature that provides for an automatic grant of additional share options whenever the option holder exercises previously granted options using the entity’s shares, rather than cash, to satisfy the exercise price.

**Reload option.** A new share option granted when a share is used to satisfy the exercise price of a previous share option.

**Service condition.** A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

**Share-based payment arrangement.** An agreement between the entity (including its shareholder or another group entity) and another party (including an employee) to enter into a share-based payment transaction, which entitles the other party to receive:

1. Cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or shares options) of the entity or another group entity; or
2. Equity instruments (including shares or share options) of the entity or another group entity, provided the specified vesting conditions are met.

**Share-based payment transaction.** A transaction in which the entity:

1. Receives goods or services from the supplier of those goods or services (including an employee) in a share-based arrangement; or
2. Incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

**Share option.** A contract that gives the holder the right, but not the obligation, to subscribe to the entity’s shares at a fixed or determinable price for a specified period of time.

**Vest.** To become an entitlement. Under a share-based payment arrangement, a counterparty’s right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of specified vesting conditions.

**Vesting condition.** A condition that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting condition is either a service condition or a performance condition.

**Vesting period.** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

## OVERVIEW

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In accordance with IFRS 2, a share-based payment is a transaction in which the entity receives goods or services as consideration for its equity instruments or acquires goods or services by incurring liabilities for amounts that are based on the price (or value) of the

entity's shares (or other equity instruments of the entity). The concept of share-based payments is broad and includes not only employee share options but also share appreciation rights, employee share ownership plans, employee share purchase plans, share option plans and other share arrangements. The accounting approach for the share-based payment depends on whether the transaction is settled by the issuance of:

1. Equity instruments;
2. Cash; or
3. Equity and cash.

The general principle is that all share-based payment transactions should be recognized in the financial statements at fair value, with asset or expense recognized when the goods or services are received. Depending on the type of share-based payment, fair value may be determined based on the value of goods or services received, or by the value of the shares or rights to shares given up. In accordance with IFRS, the following rules should be followed:

- If the share-based payment is for goods or services other than employees, the share-based payment should be measured by reference to the fair value of goods and services received;
- If the share-based payment is to employees (or those similar to employees), the transaction should be measured by reference to the fair value of the equity instruments granted at the date of grant;
- For cash-settled share-based payments, the fair value should be determined at each reporting date; and
- If the share-based payment can be settled in cash or in equity, then the equity component should be measured at the grant date only, but the cash component is measured at each reporting date.

In general, transactions in which goods or services are received as consideration for equity instruments of the entity are to be measured at the fair value of the goods or services received by the reporting entity. However, if their value cannot be readily determined (as the standard suggests is the case for employee services in limited situations) they are to be measured with reference to the fair value of the equity instruments granted.

In the case of transactions with parties other than employees, there is a rebuttable presumption that the fair value of the goods or services received is more readily determinable than is the value of the shares granted. This follows logically from the fact that, in arm's-length transactions, it should be the case that management would be highly cognizant of the value it has received (whether merchandise, plant assets, personal services, etc.) and that such data would not pose any effort to gather and utilize. Arguments to the contrary raise basic questions about managerial performance and corporate governance and can rarely be given much credence.

Additional guidance is also provided in the standard with regard to situations in which the entity cannot identify specifically some or all of the goods or services received. If the identifiable consideration received (if any) appears to be less than the fair value of the equity instruments granted or liability incurred, typically this situation indicates that other consideration (i.e., unidentifiable goods or services) has also been (or will be) received. The entity should measure the unidentifiable goods or services received (or to be received) at the grant date as the difference between the fair value of the share-based payment given or promised and the fair value of any identifiable goods or services received (or to be received).

However, for cash-settled transactions, the liability is measured at each reporting date until it is settled.

Given the added challenge of estimating fair value for non-traded shares, this was a major point of contention among those responding to the initial draft standard. Realistically, entities granting share-based compensation to executives and other employees almost always have a sense of the value being transferred, for otherwise these bargained transactions would not make business sense, nor would they satisfy the demands or expectations of the recipients.

Where payment is made or promised in the reporting entity's shares only, the value is determined using a fair value technique that computes the cost at the date of the transaction, which is not subsequently revised, except for revised terms which increase the amount of fair value to be transferred to the recipients. In contrast, for cash-settled transactions, the liability should be remeasured at each reporting date until it is settled.

For transactions measured at the fair value of the equity instruments granted (such as compensation transactions with employees), fair value is estimated at grant date. A point of contention here has often been whether grant date or exercise date is the more appropriate reference point, but the logic of the former is that the economic decision, and the employee's contractual commitment, were made as of the grant date, and the accidents of timing of subsequent exercise (or, in some cases, forfeiture) are not indicative of the bargained-for value of the transaction. The grant date is when the employee accepts the commitment, not when the offer is first made. Accordingly, IFRS 2 requires the use of grant date to ascertain the fair value to be associated with the transaction.

When share capital is issued immediately, measurement is not generally difficult. For example, if 100 shares having a fair (market) value of €33 per share are given outright to an employee, the compensation cost is simply computed as €3,300. Since the grant vests immediately (no future service is demanded from the recipient), the expense is immediately reported.

The more problematic situation is when employees (or others) are granted *options* to later acquire shares that permit exercise over a defined time horizon. The holders' ability to wait and later assess the desirability of exercising the options has value—and the lengthier the period until the options expire, the more likely the underlying shares will increase in value, and thus the greater is the value of the option. Even if the underlying shares are publicly traded, the value of the options will be subject to some debate. Only when the options themselves are traded (which is rarely the case with employee share options, which are restricted to the grantees themselves) will fair value be directly determinable by observation. If market options on the entity's shares do trade, the value will likely exceed that to be attributed to non-tradable employee share options, even if having nominally similar terms (exercise dates, prices, etc.).

The standard holds that, to estimate the fair value of a share option in the likely instance where an observable market price for that option does not exist, an *option pricing model* should be used. IFRS 2 does not specify which particular model should be used. The entity must disclose the model used, the inputs to that model, and various other information bearing on how fair value was computed. In practice, these models are all fairly sophisticated and complicated (although commercially available software promises to ease the computational complexities) and a number of the variables have inherently subjective aspects.

One issue that has to be dealt with involves the tax treatment of options, which varies across jurisdictions. In most instances the tax treatment will not comply with the fair value measurement mandated under IFRS 2, and thus there will be a need for specific guidance as

to the accounting for the tax effects of granting the options and of the ultimate exercise of those options, if they are not forfeited by the option holders. This is described later in this discussion.

In respect of the appropriate tax treatment of share-based payments, the *Basis for Conclusions* of IFRS 2 notes that in jurisdictions where a tax deduction is given, the measurement of the tax deduction does not always coincide with that of the accounting deduction. Where the tax deduction is in excess of the expense reported in the statement of profit or loss and other comprehensive income, the excess is taken directly to equity.

## RECOGNITION AND MEASUREMENT

The entity recognizes the goods or services received or acquired in a share-based payment transaction when ownership of the goods passes, or when the services have been rendered. A corresponding increase in equity is recognized if the goods or services were received in a transaction that was settled through the issuance of shares, or as an increase in liabilities if the goods or services were acquired in a cash-settled share-based payment transaction. If the goods or services acquired do not meet the qualification criteria for recognition as an asset, the transaction should be recognized as an expense.

### Example—Construction services settled by issuing shares

A contractor has been appointed to complete alterations to buildings owned by Bangkok. The contract price is fixed at €2,200,000. After completion of specific milestones, the work is certified by independent controllers. On receipt of a certificate, 50% of the amount certified is payable in cash, and the balance by issuing shares at their market value to settle the remaining 50% balance. The shares have a nominal value of €5. On March 31, 20XX Bangkok received a certificate of €2,200,000 when the fair value of the shares was €40. The number of shares to be issued is 27,500 shares [(€2,200,000 × 50%)/€40].

#### Journal

March 31, 20XX

Building under construction (SFP)	2,200,000	
Bank (SFP)		1,100,000
Share capital (Equity)		137,500
Share premium (Equity)		962,500

*Recognition of payments in respect of the expansion of the building.*

*(27,500 × €5) and (27,500 × €35)*

### Recognition When There are Vesting Conditions

In certain instances, equity instruments, which accrue immediately, are granted to employees; as such, these instruments immediately accrue to the employees. In essence, this means that the employees are not required to provide any additional service to the entity or meet any performance condition before they are unconditionally entitled to those equity instruments. In the absence of facts that contradict this position, the entity is required to recognize the associated employee cost in full with a corresponding increase in equity. It is presumed that the services rendered by the employee as consideration for the equity instruments have already been received by the grant date.

With equity instruments that do not vest until the employee completes a specified period of service or meets a specified performance condition, the entity assumes that the services rendered by the employee as consideration for those equity instruments, will only be received in the future. As such, the entity accounts for those services as they are rendered over the vesting period with a corresponding increase in equity.

**Example—Vesting condition (Service condition)**

The eight directors of San Francisco each received an option at January 1, 20X1 to take up 100 €1 shares in San Francisco for a purchase consideration of €30 per share after the completion of a two-year service period. San Francisco obtained the services of a valuation expert who calculated the fair value of the share options provided to the directors to be €15, on January 1, 20XX.

The benefits do not vest immediately since the benefits have a two-year vesting period. The transaction should be accounted for as an equity-settled share-based payment in the accounting records.

The transaction is a share-based payment transaction with an employee and should be measured at the fair value of the equity instruments (options) at the grant date. This value should not be adjusted over the life of the share-based payment transaction.

**Calculation for 20XX**

8 directors × 100 options each × €15 fair value of options at grant date × ½ completed service period = €6,000

**Journal**

**January 1, 20XX**

Employment cost (P/L)	6,000	
Equity reserve (Equity)		6,000

*Accounting for the 20X1 share-based payments to directors.*

## **EQUITY-SETTLED SHARE-BASED PAYMENTS**

### **Goods and Services**

An entity is required to measure the goods or services received (debit) and the corresponding increase in equity (credit) based on the fair value of the goods or services received. In some instances, the fair value of the goods or services received cannot be estimated reliably, and in such a situation, the entity should measure the value of the goods or services and the related increase in equity based on the fair value of the equity instruments granted. Fair value is determined as of the date when the entity obtains the goods or the service is rendered.

### **Employees**

In respect of transactions with employees and other providers of similar services, the entity should determine the fair value of the services based on the fair value of the instruments issued. The presumption in such an instance is that one cannot reliably estimate the fair value of the services received.

The value of the instruments is determined at the grant date of such instruments. All market conditions and non-vesting conditions must be considered when the fair value of the instrument is calculated on the grant date with no subsequent adjustment for a different

outcome. Service and non-market performance conditions must be considered when the number of shares that is expected to vest is estimated.

### Service Conditions

A service condition is when a grant of shares or share options to an employee is conditional on the employee remaining in the entity's employment for a specified period of time. Service conditions are considered in determining the fair value of the shares or share options at the grant date. At each measurement date, the estimate of the number of equity instruments should be revised to equal the amount that will actually be issued to the employees or other parties. At the vesting date, the actual number of shares that vest is taken into consideration in the final estimation.

#### Example—Vesting service conditions

On January 1, 20XX, Lisbon grants 20 share options to each of its 100 employees. Each grant is subject to the condition that the employees must work for another two years. Lisbon estimates that 80% of the employees will fulfill the condition to stay for two years. During 20XX, 10 employees left, and Lisbon still estimated that 20% of the original employees will leave over the two-year period. During 20XX+1, another 15 employees left before the maturity date. The fair value of each option is estimated to be €10 at the grant date.

#### Journals

##### January 1, 20XX

Employment cost (P/L)	8,000	
Equity reserve (Equity)		8,000

*Accounting for the 20XX share-based payment employment cost.*  
 $(20 \text{ options} \times 100 \text{ employees} \times 80\% \text{ (estimated)} \times €10 \times \frac{1}{2} \text{ years})$

##### December 31, 20XX+1

Employment cost (P/L)	7,000	
Equity reserve (Equity)		7,000

*Accounting for the 20XX+1 share-based payment employment cost.*  
 $[(20 \text{ options} \times 75 \text{ employees (actual)} \times €10) = 15,000 - 8,000 = 7,000]$

### Market and Non-Market Performance Conditions

Market and non-market performance conditions may be included in the share-based transaction. An example of a market performance condition is a specified increase in the entity's credit rating. Market conditions are included in the estimation of the fair value on the grant date.

#### Example—Market performance conditions

At January 1, 20XX, Boston grants a senior executive 1,000 share options with no service conditions. The share options are exercisable on December 31, 20XX. The share options may only be exercised on December 31, 20XX, if the credit rating of Boston increases from BB to BB+ during 20XX.

Boston applied a binomial option pricing model to estimate the fair value of the options at the grant date to be €20.

The credit rating condition is a market condition and is considered in the valuation on the grant date.

Since no further vesting conditions are included, the share-based transaction is recognized at the grant date.

### Journals

#### January 1, 20XX

Employment cost (P/L)	20,000	
Equity reserve (Equity)		20,000

*Accounting for the 20XX employment cost.*  
*(1,000 shares × €20)*

A non-market performance condition is, for example, an entity achieving a specified growth in revenue. Non-market conditions are taken into account in determining the quantity of the instruments that will be issued and not in the fair value of the instrument on the grant date.

### Example—Non-market performance conditions

On January 1, 20XX, Calgary grants 40 shares to 200 employees subject to the condition that the employees remain in the employment of the entity for the vesting period. The shares will vest on December 31, 20XX, if the earnings of the entity increase by 10%, and on December 31, 20XX+1, if the earnings increase by an average of 8% per year over the two years. The shares had a fair value of €25 at the grant date.

On December 31, 20XX, the earnings only increased by 9%, 30 employees left and Calgary expects that another 20 employees will leave during the 20XX+1 financial period. Calgary expects that the vesting conditions will be met during the 20XX+1 financial period.

On December 31, 20XX+1, the vesting conditions are met since the earnings increased by 10% during 20X2. 15 employees left employment during the 20XX+1 financial period before the shares vested.

### Journals

#### 20XX

Employment cost (P/L)	75,000	
Equity reserve (Equity)		75,000

*Accounting for the 20XX share-based payment employment cost.*  
*[40 shares × 150 (200 – 30 – 20) employees (expected) × €25 × 1/2 years]*

#### 20XX+1

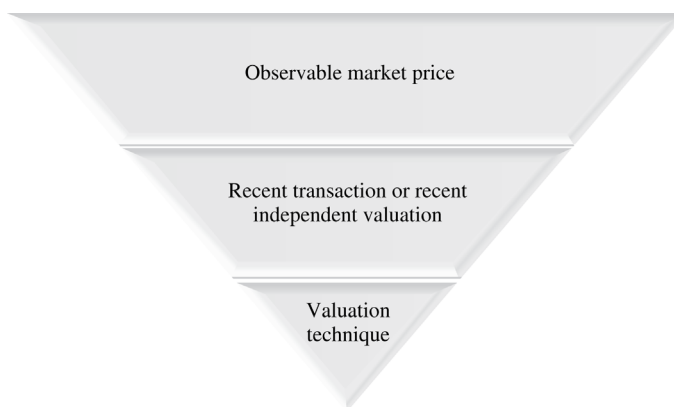
Employment cost (P/L)	80,000	
Equity reserve (Equity)		80,000

*Accounting for the 20XX+1 share-based payment employment cost.*  
*(40 shares × 155 (200-30-15) employees (actual) × €25) = 155,000 – 75,000 = 80,000*

### Measurement of Fair Value

If the fair value of the goods or services received cannot be measured reliably, the fair value of the shares, share options or equity-settled share appreciation rights must be determined using the three-tier measurement hierarchy included in Figure 17-1.





**Figure 17-1** Fair value hierarchy

Observable market price of the equity instruments granted is only used if such a price is available. This is unlikely to be applicable where an entity is not listed on a stock exchange. In the absence of observable market prices, observable market data may be used, such as:

- A recent transaction in the entity's shares.
- A recent independent fair valuation of the entity or its principal assets.

If the value of shares cannot be measured by an observable market price, or reliable measurement under level two is impractical, the shares are measured indirectly by using a valuation method. A valuation method uses, to the greatest practicable extent possible, market data that can be externally verified to arrive at a position that the equity instruments under consideration would be exchanged at the grant date between knowledgeable willing parties. Similarly, share options and share appreciation rights are valued under level three of the hierarchy by using an option pricing model. This would, in effect, be a directors' valuation, and as such the directors should apply their judgement in determining the amount. The valuation method should, however, comply with generally accepted methodologies for valuing equity instruments.

For a detailed example of calculating fair value for employee share options, see Appendix to this chapter.

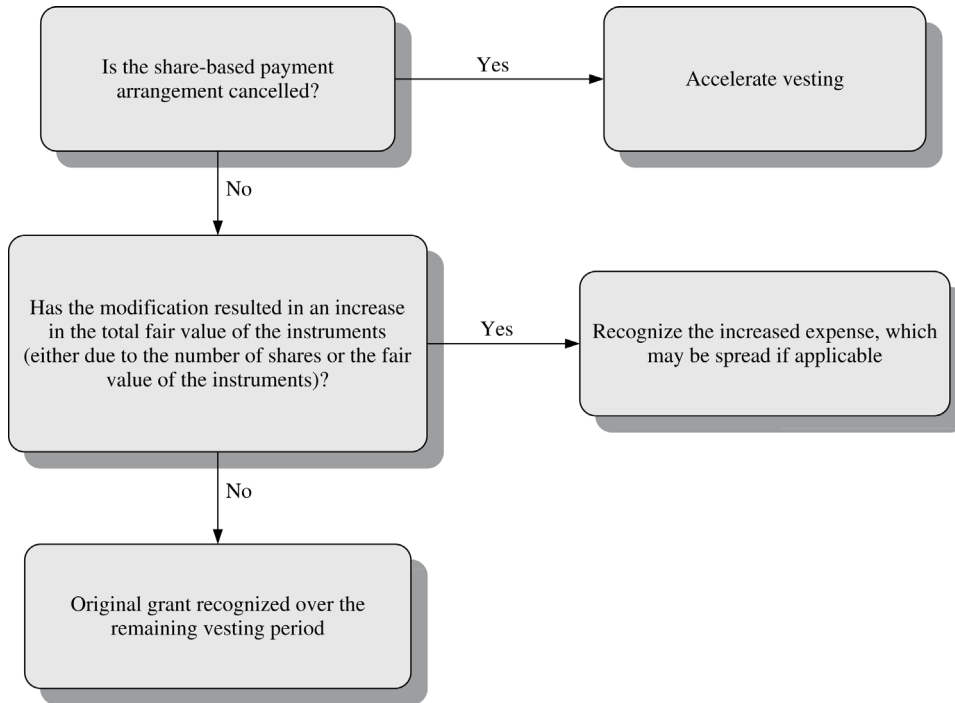
### **Modifications and Cancellations to the Terms and Conditions**

Changes in the economic conditions or circumstance of the entity may sometimes make an entity change the vesting conditions that are attached to employee share ownership schemes. The entity may modify the vesting conditions in a manner that is beneficial to the employee (for example, by reducing the exercise price of an option, or reducing the vesting period, or by modifying or eliminating a performance condition). Modification to vesting conditions is only considered if it is beneficial to the employers.

Such changes should be taken into account in accounting for the share-based payment transaction as illustrated in Figure 17-2.

### **If the Modification Increases the Fair Value**

If the modification to the scheme increases the fair value of the equity instruments granted, or the number of equity instruments granted, the entity should account for the



**Figure 17-2** Modifications and cancellations to the terms and conditions

incremental total fair value equity instruments granted as a share-based payment expense. The incremental fair value is the difference between the fair value of the modified equity instrument and the original equity instrument on the date of the modification. The balance of the original equity instrument granted is recognized over the remainder of the original vesting period.

**Example—Modification of a share-based payment transaction**

The 10 directors of Brno received options on January 1, 20XX, to take up 100 €1 shares in Brno for a purchase consideration of €20 per share after the completion of a two-year service period. Brno obtained the services of a valuation expert who calculated the fair value of the share options provided to the directors to be €11 on January 1, 20XX.

The amount recognized as a share-based expense during 20XX amounted to:

$$(100 \text{ options} \times 10 \text{ employees} \times €11 \times 1/2 \text{ years}) = €5,500$$

On January 1, 20XX+1, the share price of Brno shares decreased to €18. The directors expressed concern that their options carried no value, and requested that the entity decrease the consideration price to be paid to €15. The entity decreased the purchase consideration from €20 to €15; a valuation expert calculated the fair value of the €20 share option to be €2 and a €15 share option to be €8 as at January 1, 20XX. All the directors exercised their options on December 31, 20XX+1.

**Calculation****Original issue**

Total benefit (10 directors × 100 options each × €11)	11,000
Previously recognized	5,500
Amount still to be recognized	5,500

**Modification**

Since the incremental fair value is positive (€8 – €2), the value of the modification based on the incremental fair value is included in the share-based payment expense. The value is €6,000 [10 directors × 100 options each × (€8 – €2) incremental fair value of options at modification date × 1/1 completed service period].

**Current year expense**

€11,000 (original issue) + €6,000 (modification) – €5,500 (prior year) = €11,500

**Journals****December 31, 20XX+1**

Employment cost (P/L)	11,500	
Equity reserve (Equity)		11,500

*Accounting for the 20X2 employment cost.*

Bank (SFP)	15,000	
Equity reserve (Equity)	17,000	

*[€5,500 (20X1) + €11,500 (20X2)]*

Share capital (Equity)		1,000
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*(10 directors × 100 Brno share)*

Share premium (Equity)		31,000
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*Accounting for the issue of the share capital to honour the shares issued.*

**If the Modification Decreases the Fair Value**

If the modification reduces the total fair value of the share-based payment arrangement, or the terms are changed in such a way that the arrangement is no longer for the benefit of the employee, the entity is still required to account for the services received as consideration for the equity instruments granted as if that modification had not occurred. No changes are therefore made to the accounting for the share-based payment arrangement. Therefore, in the above example, only the €11,000 expense relating to the original issue will be recognized over the vesting period.

**Cancellations and Settlements**

Where an entity cancels or settles an equity-settled share-based payment award, it accounts for such cancellation or settlement as an acceleration of vesting. The entity, therefore, recognizes immediately in profit or loss the amount that otherwise would have been recognized for services received over the remainder of the vesting period.

**Example—Vesting service conditions**

On January 1, 20XX, Baghdad grants 30 share options to each of its 200 employees. Each grant is subject to the condition that the employees must work for Baghdad for another three years. The fair value of each option is estimated to be €10 at the grant date. Baghdad estimates that 80% of the employees will fulfill the condition to stay for three years. Based on the estimation, the following was recognized during the 20XX financial period:

Employment cost (P/L)	16,000	
Equity reserve (Equity)		16,000

*Accounting for the 20XX employment cost.*  
 $(30 \text{ options} \times 200 \text{ employees} \times 80\% \text{ (estimated)} \times €10 \times 1/3 \text{ years})$

During 20XX+1 the share-based transaction was cancelled because the options are out of the money.

The vesting period is accelerated and any outstanding balance is recognized.

Employment cost (P/L)	32,000	
Equity reserve (Equity)		32,000

*Accounting for the 20XX+1 employment cost.*  
 $(30 \text{ options} \times 200 \text{ employees} \times 80\% \times €10) = 48,000 - 16,000 = 32,000$

**Employee share options with graded vesting characteristics and service conditions**

Under IFRS 2, the compensation expense for share options with graded vesting characteristics and service conditions must be made on an accelerated attribution basis. IFRS does not permit the straight-line method for attribution of compensation cost of share options with service conditions and graded vesting characteristics. A graded vesting plan assigns the share options to the period in which they vest. This is because IFRS 2 views each tranche of vesting as a separate grant for which service has been provided since the date of the original grant.

The mandatory use of the accelerated amortization method for share options with graded vesting features results in a higher compensation cost in the earlier years of the vesting period as shown in the example below.

**Example—Vesting service conditions**

1,000 share options are granted to 100 employees at a grant price of €10 per option which gives a total share option grant value of €1,000,000. The share option plan provides for a graded vesting of these 1,000 share options, in four equal tranches over a four-year period (or 25%) at each anniversary of the grant. Ignore forfeiture rates for this example. Under the accelerated attribution method, the compensation cost for each of the four years is as follows:

	Year 1	Year 2	Year 3	Year 4
First year vesting 25%	€250,000			
Second year vesting 25%	125,000	€125,000		
Third year vesting 25%	83,333	83,333	€83,333	
Fourth year vesting 25%	62,500	62,500	62,500	€62,500
Total compensation cost for each of the years	520,833	270,833	145,833	62,500

Accordingly, options which vest in Year 2 are deemed to have a two-year vesting period and the ones which vest in Year 3 have a three-year vesting period. The accelerated attribution method

shows that the compensation cost for graded options is highly front loaded from the year of grant. The straight-line method of attribution followed under US GAAP would have resulted in a share option compensation expense of only €250,000 in Year 1 compared to €520,833 under IFRS.

## CASH-SETTLED SHARE-BASED PAYMENTS

For cash-settled share-based payment transactions, an entity is required to measure the goods or services acquired and the liability incurred at the fair value of the liability. Thereafter, the liability is remeasured to its fair value at each reporting date until such time that it is settled. Any movements in the fair value of the liability are recognized in profit or loss for the period.

### Example—Cash-settled share-based payment

At January 1, 20XX, Casablanca grants a cash-settled share-based payment transaction to 100 employees. In terms of the transaction, each employee is entitled to receive the increase of the independent value of the 10 shares of Casablanca above €20, in cash, after a vesting period of two years' service.

On January 1, 20XX, it was expected that 90% of the employees will still be in service on the vesting date. The actual number of employees in service on December 31, 20XX+1, was 88.

The independent expert valued the right attached to one share as follows:

December 31, 20XX	€6
December 31, 20XX+1	€9

The full liability was settled on December 31, 20XX+1.

#### Journals

##### December 31, 20XX

Employment cost (P/L)	2,700	
Share-based payment liability (SFP)		2,700

*Accounting for the 20X1 share-based payment employment cost.*  
*(10 shares × 100 employees × 90% × €6 × 1/2 years)*

##### December 31, 20XX+1

Employment cost (P/L)	5,220	
Share-based payment liability (SFP)		5,220

*Accounting for the 20XX+1 employment cost.*  
*[10 shares × 88 employees (actual) × €9] = 7,920 - 2,700 = 5,220*

For reference, please also read the section on Future Development in this chapter with respect to the proposed amendments relating to accounting for the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payment to follow the approach used for measuring equity-settled share-based payments.

## SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES

The share-based payment agreements entered into may give the parties to the agreement a choice of settling the transaction in cash or through the transfer of equity instruments.

Where such a choice exists, the transaction is accounted for as a cash-settled share-based payment transaction unless either of the following criteria is met:

- There has been a past practice of settling obligations by issuing equity instruments (which can be demonstrated).
- The option has no commercial substance because the cash settlement amount bears no relationship to, and is likely to be lower in value than, the fair value of the equity instrument. As such, the likelihood of the settlement taking place in cash is, at best, very remote.

If either of these two criteria is met, then the entity can account for the transaction as an equity-settled share-based payment transaction.

#### Example—Settlement alternatives

On January 1, 20XX, Brighton grants 1,000 shares to a senior executive, subject to service condition of two years. Each share has a fair value of €25 at the grant date. The executive can choose to receive the 1,000 shares, or cash equal to the value of 1,000 shares, on the vesting date. The fair value of the shares is:

December 31, 20XX	€27
December 31, 20XX+1	€31

The transaction is recorded as a cash-settled share-based payment because the executive has a choice of settlement.

#### January 1, 20XX

Employment cost (P/L)	13,500	
Share-based payment liability (SFP)		13,500

*Accounting for the 20XX employment cost.  
(1,000 shares × €27 × 1/2 years)*

#### December 31, 20XX+1

Employment cost (P/L)	17,500	
Share-based payment liability (SFP)		17,500

*Accounting for the 20XX+1 employment cost.  
[(1,000 shares × €31) = 31,000 – 13,500 = 17,500]*

## SHARE-BASED TRANSACTIONS AMONG GROUP ENTITIES

The 2009 amendments to IFRS 2 incorporated the guidance contained previously in IFRIC 11 (and IFRIC 11, *Group and Treasury Share Transactions*, accordingly was withdrawn). For share-based transactions among group entities, in its separate or individual financial statements, the entity receiving the goods or services should measure the expense as either an *equity-settled* or *cash-settled* share-based transaction by assessing:

1. The nature of the awards granted; and
2. Its own rights and obligations.

The entity receiving goods or services may recognize a different amount than the amount recognized by the consolidated group or by another group entity settling the share-based payment transaction.

The entity should measure the expense as an *equity-settled* share-based payment transaction (and remeasure this expense only for changes in vesting conditions) when:

1. The awards granted are its own equity instruments; or
2. The entity has no obligation to settle the share-based payment transaction.

In all other cases, the expense should be measured as a *cash-settled* share-based payment transaction. Consequently, the entity should recognize the transaction as an *equity-settled* share-based transaction *only* if it is to be settled in the entity's own equity instruments (in all other circumstances the transaction is a *cash-settled* share-based payment transaction). In group transactions based on repayment arrangements that require the payment of the equity instruments to the suppliers of goods or services, the entity receiving goods or services should recognize the share-based payment expense regardless of repayment arrangements.

For example, there are various circumstances whereby a parent entity's equity shares are granted to employees of its subsidiaries. One common situation occurs where the parent is publicly traded but its subsidiaries are not (e.g., where the subsidiaries are wholly owned by the parent company), and thus the parent company's shares are the only "currency" that can be used in share-based payments to employees. If the arrangement is accounted for as an equity-settled transaction in the consolidated (group) financial statements of the parent company, the subsidiary is to measure the services under the equity-settled share-based payment transaction. A capital contribution by the parent is also recognized by the subsidiary in such situations.

Furthermore, if the employee transfers from one subsidiary to another, each is to measure compensation expense by reference to the fair value of the equity instruments at the date the rights were granted by the parent, allocated according to the relative portion of the vesting period the employee works for each subsidiary. There is no remeasurement associated with the transfer between entities. If a vesting condition other than a market condition (defined by IFRS 2, Appendix A) is not met and the share-based compensation is forfeited, each subsidiary adjusts previously recognized compensation cost to remove cumulative compensation cost from each of the subsidiaries.

On the other hand, if the subsidiary grants rights to its parent company's shares to the subsidiary's employees, that entity accounts for this as a cash-settled transaction. This means the obligation is reported as a liability, and adjusted to fair value at each reporting date.

In group transactions based on repayment arrangements that require the payment of the equity instruments to the suppliers of goods or services, the entity receiving goods or services should recognize the share-based payment expense regardless of repayment arrangements.

## DISCLOSURE

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IFRS 2 imposes extensive disclosure requirements, calling for an analysis of share-based payments made during the year, of their impact on earnings and financial position, and of the basis upon which fair values were measured. An entity should disclose information enabling users of the financial statements to understand the nature and extent of share-based payment transactions that occurred during the period.

Each type of share-based payment transaction that existed during the year must be described, giving vesting requirements, the maximum term of the options, and the method of settlement (but entities that have several “substantially similar” schemes may aggregate this information). The movement (i.e., changes) within each scheme must be analysed, including the number of share options and the weighted-average exercise price for the following:

- Outstanding at the beginning of the year;
- Granted during the year;
- Forfeited during the year;
- Exercised during the year (plus the weighted-average share price at the time of exercise);
- Expired during the year;
- Outstanding at the end of the period (plus the range of exercise prices and the weighted-average remaining contractual life);
- Exercisable at the end of the period.

The entity must disclose the total expense recognized in the statement of profit or loss and other comprehensive income arising from share-based payment transactions, and a subtotal of that part which was settled by the issue of equity. Where the entity has liabilities arising from share-based payment transactions, the total amount at the end of the period must be separately disclosed, as must be the total intrinsic value of those options that had vested.

The fair value methodology disclosures apply to new instruments issued during the reporting period, or old instruments modified in that time. Regarding share options, the entity must disclose the weighted-average fair value, plus details of how fair value was measured. These will include the option pricing model used, the weighted-average share price, the exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs. The measurement of expected volatility must be explained, as must be the manner in which any other features of the option were incorporated in the measurement.

Where a modification of an existing arrangement has taken place, the entity should provide an explanation of the modifications, and disclose the incremental fair value and the basis on which that was measured (as above).

Where a share-based payment was made to a non-employee, such as a vendor, the entity should confirm that fair value was determined directly by reference to the market price for the goods or services.

If equity instruments *other than share options* were granted during the period, the number and weighted-average fair value of these should be disclosed together with the basis for measuring fair value, and if this was not market value, then how it was measured. The disclosure should cover how expected dividends were incorporated into the value and what other features were incorporated into the measurement.

### **Financial Statement Presentation under IFRS**

The following is an illustration of the treatment of equity that may be required in the financial statements.



## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

**xx. Share based payments**

[A description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g. whether in cash or equity)].

IFRS2  
p44  
p45

	20XX		20XX-1		
	Options	Weighted average exercise price	Options	Weighted average exercise price	
Outstanding at the beginning of the period	X	X	X	X	IFRS2 p44 p45
Granted during the period	X	X	X	X	
Forfeited during the period	X	X	X	X	
Exercised during the period	X	X	X	X	
Expired during the period	X	X	X	X	
Outstanding at the end of the period	X	X	X	X	
Exercisable at the end of the period	X	X	X	X	

The weighted average share price of share options exercised during the period at the date of exercise was £X.

IFRS2  
p44  
p45

Share options outstanding at 31 December 20XX had a weighted average exercise price of £ X, and a weighted average remaining contractual life of X years.

IFRS2  
p44  
p45

[Disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.]

IFRS2  
p46

The fair value of share based payment instruments were determined by the Black-Scholes Merton model. The effect of non-transferability has been taken into accounting by adjusting the expected life of the instruments. Volatility was calculated based on the share price volatility over a similar period preceding the grant date.

IFRS2  
p51

Inputs into the model	X
Grant date share price	X
Exercise price	X
Expected volatility	X %
Option life	X years
Dividend yield	X %
Risk-free interest rate	X %

	20XX	20XX-1	IFRS2 p51
Total expense recognized from share based payment transactions	X	X	
Equity settled share based payment expense	X	X	
Share based payment liability	X	X	
Intrinsic value of liabilities arising from vested rights	X	X	

## FUTURE DEVELOPMENTS

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### IASB's Work Plan for IFRS 2

IASB has issued a ED/2014/5 on proposed amendments to IFRS 2. Essentially, this will be addressing the following matters:

- The IASB proposes to clarify that accounting for the effects of vesting and non-vesting conditions on the measurement of a cash-settled share-based payment should follow the approach used for measuring equity-settled share-based payments in paragraphs 19–21A of IFRS 2.
- The IASB proposes to specify that if the entity settles the share-based payment arrangement net by withholding a specified portion of the equity instruments to meet the statutory tax withholding obligation, then the transaction should be classified as equity-settled in its entirety, if the entire share-based payment would otherwise be classified as equity-settled if it had not included the net settlement feature.
- The IASB proposes to amend IFRS 2 so that:
  - (a) the share-based payment transaction is measured by reference to the modification-date fair value of the equity instruments granted as a result of the modification;
  - (b) the liability recognized in respect of the original cash-settled share-based payment is derecognized upon the modification, and the equity-settled share-based payment is recognized to the extent that the services have been rendered up to the modification date; and
  - (c) the difference between the carrying amount of the liability as at the modification date and the amount recognized in equity at the same date is recorded in profit or loss immediately.

## US GAAP COMPARISON

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IFRS and US GAAP accounting for share-based payments contain many of the same elements. However, there are several differences. The definitions of employees differ. US GAAP focuses primarily on the common law definition, while IFRS has a more general definition. Like IFRS, US GAAP measures share-based payments using fair value. For awards to non-employees, US GAAP uses the fair value of the more reliable of (a) the goods or services received, or (b) the equity instruments granted. However, compensation to employees is generally measured using the fair value of the awards. IFRS uses the fair value of the goods or services received, and only uses the fair value of the equity instruments granted in the rare circumstances that the fair value of the goods and services cannot be reliably estimated.

For non-employee awards, the US GAAP measurement date is the earlier of the date at which a commitment for performance by the counterparty is reached or the date at which the counterparty's performance is complete. From the commitment date until the date of performance, the awards are remeasured at each reporting date and the change in value recognized in the income statement. The IFRS measurement date is the date the entity obtains the goods or the counterparty renders the services. IFRS does not have a performance commitment concept.

Both IFRS and US GAAP allocate the costs across the vesting periods. However, under US GAAP, a performance target that affects vesting to be achieved after an employee's requisite service period shall be accounted for as a performance condition. As such, the performance target does not affect the fair value of the award but the vesting period may be longer than the requisite service period. (ASC 718-10-30-28)

US GAAP has more detailed implementation guidance for determining fair value model assumptions, including exceptions or accommodations to the general principles that may result in an award being assigned different values under US GAAP. One such exception is that a non-public entity may use intrinsic value if the fair value of the awards is not reliable. US GAAP encourages the use of Black-Scholes or the lattice method of computing fair value, whereas IFRS does not.

For awards with graded vesting features, US GAAP allows entities to make an accounting policy election to recognize compensation cost for awards containing only service conditions. The recognition can be on a straight-line or accelerated basis, regardless of whether the fair value of the award is measured based on the award as whole or for each individual tranche. Under IFRS, entities must recognize compensation cost on an accelerated basis and each individual tranche must be separately measured.

Under US GAAP, modifications of awards require new measurement based on date of modification. Under IFRS, modifications do not trigger new measurement of fair value. Differences exist between the models related to, for example, the modification of an improbable award (to a probable award) and a modification that results in a change in classification of an award from equity to liability.

US GAAP calculates deferred taxes based on the cumulative GAAP expense recognized and adjusted upon realization of the tax benefit. The IFRS calculation is based on the estimated tax deduction determined at each reporting date. Under US GAAP, windfall benefits reccredited to shareholders' equity. Any shortfall is charged to shareholder's equity to the extent of prior windfall benefits, and then to tax expense. Under IFRS, if deferred tax based on the excess of the tax deduction exceeds cumulative compensation cost is credited to shareholders' equity. However, if the tax deduction is less than or equal to cumulative compensation cost, deferred taxes are recorded in income. US GAAP requires liability classification of an award if the employee does not bear the risks and rewards of equity ownership for at least six months from the date the shares vest until issue. IFRS does not have a six-month consideration.

The guidance for classification of awards differs under IFRS and US GAAP. Under US GAAP, share-based payment awards granted by a subsidiary to its employees and to be settled by parent's equity instruments are classified as equity in the subsidiary's separate financial statements. Under IFRS, share-based payment awards granted by a subsidiary to its employees and to be settled by parent's equity instrument are classified as equity or liabilities, based on the nature of the award and the subsidiary's rights and obligations, in the subsidiary's separate financial statements.

## APPENDIX: EMPLOYEE SHARE OPTIONS VALUATION EXAMPLE

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An entity should expense the value of share options granted to an employee over the period during which the employee is earning the option—that is, the period until the option vests (becomes unconditional). If the options vest (become exercisable) immediately, the employee receiving the grant cannot be compelled to perform future services, and accordingly the fair value of the options is compensation in the period of the grant. More commonly, however, there will be a period (several years, typically) of future services required before the options may be exercised; in those cases, compensation is to be recognized over that vesting period. There are two practical difficulties with this:

1. Estimating the value of the share options granted (true even if vesting is immediate); and
2. Allowing for the fact that not all options initially granted will ultimately vest or, if they vest, be exercised by the holders.

IFRS 2 requires that where directly observable market prices are not available (which is virtually always the case for employee share options, since they cannot normally be sold), the entity must estimate fair value using a valuation technique that is “consistent with generally accepted valuation methodologies for pricing financial instruments, and shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.” No specific valuation method is endorsed by the standard, however.

Appendix B of the standard notes that all acceptable option pricing models take into account:

- The exercise price of the option;
- The current market price of the share;
- The expected volatility of the share price;
- The dividends expected to be paid on the shares;
- The risk-free interest rate;
- The life of the option.

In essence, the grant date value of the share option is the current market price, less the present value of the exercise price, less the dividends that will not be received during the vesting period, adjusted for the expected volatility. The time value of money, as is well understood, arises because the holder of an option is not required to pay the exercise price until the exercise date. Instead, the holder of the option can invest his funds elsewhere, while waiting to exercise the option. According to IFRS 2, the time value of money component is determined by reference to the rate of return available on *risk-free* securities. If the share pays a *dividend*, or is expected to pay a dividend during the life of the option, the value to the holder of the option from delaying payment of the exercise price is only the excess (if any) of the return available on a risk-free security over the return available from exercising the option today and owning the shares. The time value of money component for a dividend-paying share equals the discounted present value of the expected interest income that could be earned less the discounted present value of the expected dividends that will be foregone during the expected life of the option.

The time value associated with *volatility* represents the ability of the holder to profit from appreciation of the underlying shares while being exposed to the loss of only the option premium, and not the full current value of the shares. A more volatile share has a higher

probability of big increases or decreases in price, compared with one having lower volatility. As a result, an option on a highly volatile share has a higher probability of a big payoff than an option on a less volatile share, and so has a higher value relating to volatility fair value component. The longer the option term, the more likely, for any given degree of volatility, that the share price will appreciate before option expiration, making exercise attractive. Greater volatility, and longer term, each contribute to the value of the option.

Volatility is the measure of the amount by which a share's price fluctuates during a period. It is expressed as a percentage because it relates share price fluctuations during a period to the share's price at the beginning of the period. Expected annualized volatility is the predicted amount that is the input to the option pricing model. This is calculated largely from the share's historical price fluctuations.

To illustrate this basic concept, assume that the present market price of the underlying shares is €20 per share, and the option plan grants the recipient the right to purchase shares at today's market price at any time during the next five years. If a risk-free rate, such as that available on government treasury notes having maturities of five years is 5%, then the present value of the future payment of €20 is €15.67  $\{= [\text{€}20 \div (1.05)^5]\}$ , which suggests that the option has a value of  $(\text{€}20 - \text{€}15.67 =) \text{€}4.33$  per share before considering the value of lost dividends. If the shares are expected to pay a dividend of €0.40 per share per year, the present value of the dividend stream that the option holder will forego until exercise five years hence is about €1.64, discounting again at 5%. Therefore, the *net* value of the option being granted, assuming it is expected to be held to the expiration date before being exercised, is  $(\text{€}4.33 - \text{€}1.64 =) \text{€}2.69$  per share. (Although the foregoing computation was based on the full five-year life of the option, the actual requirement is to use the *expected term* of the option, which may be shorter.)

Commercial software is readily available to carry out these calculations. However, accountants must understand the theory underlying these matters so that the software can be appropriately employed and the results verified. Independent auditors, of course, have additional challenges in verifying the financial statement impacts of share-based compensation plans.

Estimating volatility does, however, involve special problems for unlisted or newly listed companies, since the estimate is usually based on an observation of past market movements, which are not available for such entities. The *Basis for Conclusions* says that IASB decided that, nonetheless, an estimate of volatility should still be made. Appendix B of IFRS 2 states that newly listed entities should compute actual volatility for whatever period this information is available, and should also consider volatility in the prices of shares of other companies operating in the same industry. Unlisted entities should consider the volatility of prices of listed entities in the same industry, or, where valuing them on the basis of a model, such as net earnings, should use the volatility of the earnings.

IASB considered the effect of the *non-transferability* on the value of the option. The standard option pricing models (such as Black-Scholes) were developed to value traded options and do not take into account any effect on value of non-transferability. It came to the view that non-transferability generally led to the option being exercised early, and that this should be reflected in the expected term of the option, rather than by any explicit adjustment for non-transferability itself.

The likelihood of the option vesting is a function of the vesting conditions. IASB concluded that these conditions should not be factored into the value of the option, but should be reflected in calculating the number of options to be expensed. For example, if an

entity granted options to 500 employees, the likelihood that only 350 would satisfy the vesting conditions should be used to determine the number of options expensed, and this should be subsequently adjusted in the light of actual experience as it unfolds.

***Employee share options: Valuation models***

IFRS 2 fully imposes a fair value approach to measuring the effect of share options granted to employees. It recognizes that directly observable prices for employee options are not likely to exist, and thus that valuation models will have to be employed in most, or almost all, instances. The standard speaks to the relative strengths of two types of approaches: the venerable Black-Scholes (now called Black-Scholes-Merton, or BSM) option pricing model, designed specifically to price publicly traded European-style options (exercisable only at the expiration date) and subject to criticism as to possible inapplicability to non-marketable American-style options; and the mathematically more challenging but more flexible lattice models, such as the binomial. IFRS 2 does not dictate choice of model and acknowledges that the Black-Scholes model may be validly applied in many situations.

To provide a more detailed examination of these two major types of options valuation approaches, several examples will now follow.

Both valuation models (hereinafter referred to as BSM and binomial) must take into account the following factors, at a minimum:

1. Exercise price of the option.
2. Expected term of the option, taking into account several things including the contractual term of the option, vesting requirements, and post-vesting employee termination behaviours.
3. Current price of the underlying share.
4. Expected volatility of the price of the underlying share.
5. Expected dividends on the underlying share.
6. Risk-free interest rate(s) for the expected term of the option.

In practice, there are likely to be ranges of reasonable estimates for expected volatility, dividends and option term. The closed form models, of which BSM is the most widely regarded, are predicated on a set of assumptions that remain invariant over the full term of the option. For example, the expected dividend on the shares on which options are issued must be a fixed amount each period over the full term of the option. In the real world, of course, the condition of invariability is almost never satisfied. For this reason, current thinking is that a lattice model, of which the binomial model is an example, would be preferred. Lattice models explicitly identify nodes, such as the anniversaries of the grant date, at each of which new parameter values can be specified (e.g., expected dividends can be independently defined each period).

Other features that may affect the value of the option include changes in the issuer's credit risk, if the value of the awards contains cash settlement features (i.e., if they are liability instruments). Also, contingent features that could cause either a loss of equity shares earned or reduced realized gains from sale of equity instruments earned, such as a "clawback" feature (for example, where an employee who terminates the employment relationship and begins to work for a competitor is required to transfer to the issuing entity shares granted and earned under a share-based payment arrangement).

Before presenting specific examples of accounting for share options, simple examples of calculating the fair value of options using both the BSM and the binomial methods are provided. First, an example of the BSM, closed-form model is provided.

BSM actually computes the theoretical value of a “European” call option, where exercise can occur only at the expiration date. “American” options, which describes most employee share options, can be exercised at any time until expiration. The value of an American-style option on dividend-paying shares is generally greater than a European-style option, since pre-exercise, the holder does not have a right to receive dividends that are paid on the shares. (For non-dividend-paying shares, the values of American and European options will tend to converge.) BSM ignores dividends, but this is readily dealt with, as shown below, by deducting from the computed option value the present value of expected dividend stream over the option holding period.

BSM also is predicated on constant volatility over the option term, which available evidence suggests may not be a wholly accurate description of share price behaviour. On the other hand, the reporting entity would find it very difficult, if not impossible, to compute differing volatilities for each node in the lattice model described later in this section, lacking a factual basis for presuming that volatility would increase or decrease in specific future periods.

The BSM model is:

$$C = SN(d_1) - Ke^{-rt}N(d_2)$$

Where:

C	=	Theoretical call premium
S	=	Current share price
t	=	Time until option expiration
K	=	Option striking price
r	=	Risk-free interest rate
N	=	Cumulative standard normal distribution
e	=	Exponential term (2.7183)
d <sub>1</sub>	=	$\frac{\ln(S/K) + (r + s^2/2)t}{Sv\sqrt{t}}$
d <sub>2</sub>	=	d <sub>2</sub> = d <sub>1</sub> - s
s	=	Standard deviation of share returns
ln	=	Natural logarithm

The BSM valuation is illustrated with the following assumed facts; note that dividends are ignored in the initial calculation but will be addressed once the theoretical value is computed. Also note that volatility is defined in terms of the variability of the entity’s share price, measured by the standard deviation of prices over the past three years, which is used as a surrogate for expected volatility over the next 12 months.

**Example—Determining the fair value of options using the BSM model**

BSM is a closed-form model, meaning that it solves for an option price from an equation. It computes a theoretical call price based on five parameters—the current share price, the option exercise price, the expected volatility of the share price, the time until option expiration, and the short-term risk-free interest rate. Of these, expected volatility is the most difficult to ascertain. Volatility is generally computed as the standard deviation of recent historical returns on the shares. In the following example, the shares are currently selling at €40 and the standard deviation of prices (daily closing prices can be used, among other possible choices) over the past several years was €6.50, thus yielding an estimated volatility of €6.50/€40 = 16.25%.

Assume the following facts:

S	=	€40
t	=	2 years
K	=	€45
r	=	3% annual rate
s	=	Standard deviation of percentage returns = 16.25% (based on €6.50 Standard deviation of share price compared to current €40 price)

From the foregoing data, all of which is known information (the volatility,  $s$ , is computed or assumed, as discussed above) the factors  $d_1$  and  $d_2$  can be computed. The cumulative standard normal variates ( $N$ ) of these values must then be determined (using a table or formula), following which the BSM option value is calculated, *before the effect of dividends*. In this example, the computed amounts are:

$$N(d_1) = 0.2758$$

$$N(d_2) = 0.2048$$

With these assumptions the value of the share options is approximately €2.35. This is derived from the BSM as follows:

$$\begin{aligned} C &= SN(d_1) - Ke^{-rt}N(d_2) \\ &= 40(.2758) - 45(.942)(.2048) \\ &= 11.032 - 8.679 \\ &= 2.35 \end{aligned}$$

The foregone two-year stream of dividends, which in this example are projected to be €0.50 annually, have a present value of €0.96. Therefore, the net value of this option is €1.39 (= €2.35 - .96).

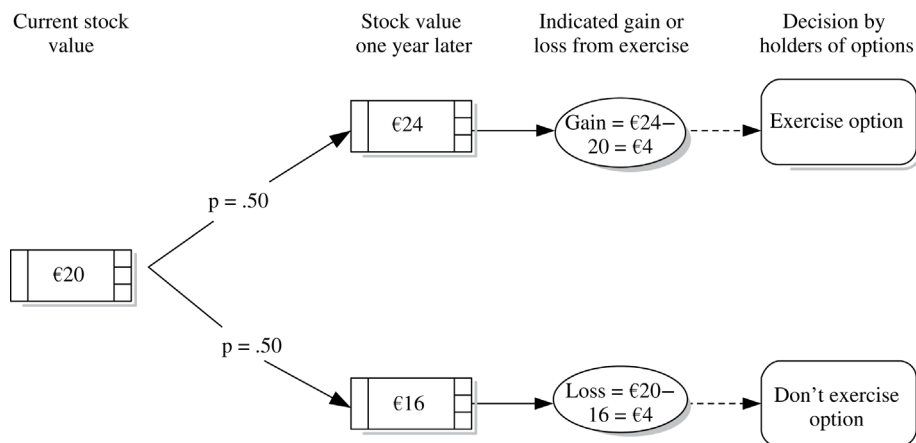
#### Example—Determining the fair value of options using the binomial model

In contrast to the BSM, the binomial model is an open form, inductive model. It allows for multiple (theoretically, unlimited) branches of possible outcomes on a “tree” of possible price movements and induces the option’s price. As compared to the BSM approach, this relaxes the constraint on exercise timing. It can be assumed that exercise occurs at any point in the option period, and past experience may guide the reporting entity to make certain such assumptions (e.g., that one-half of the options will be exercised when the market price of the shares reach 150% of the strike price). It also allows for varying dividends from period to period.

It is assumed that the common (Cox, Ross and Rubinstein) binomial model will be used in practice. To keep this preliminary example relatively simple in order to focus on the concepts involved, a single-step binomial model is provide here for illustrative purposes. Assume an option is granted of a €20 share that will expire in one year. The option exercise price equals the share price of €20. Also, assume there is a 50% chance that the price will jump 20% over the year and a 50% chance the shares will drop 20%, and that no other outcomes are possible. The risk-free interest rate is 4%. With these assumptions there are three basic calculations:

1. Plot the two possible future share prices.
2. Translate these share prices into future options values.
3. Discount these future values into a single present value.





In this case, the option will only have value if the share price increases, and otherwise the option would expire worthless and unexercised. In this simplistic example, there is only a 50% chance of the option having a value of ( $€4 \div 1.04 = €3.84$ ), and therefore the option is worth ( $€3.84 \times .50 = €1.92$ ) at grant date.

The foregoing was a simplistic single-period, two-outcome model. A more complicated and realistic binomial model extends this single-period model into a randomized walk of many steps or intervals. In theory, the time to expiration can be broken into a large number of ever-smaller time intervals, such as months, weeks or days. The advantage is that the parameter values (volatility, etc.) can then be varied with greater precision from one period to the next (assuming, or course, that there is a factual basis for these estimates). Calculating the binomial model then involves the same three calculation steps. First, the possible future share prices are determined for each branch, using the volatility input and time to expiration (which grows shorter with each successive node in the model). This permits computation of terminal values for each branch of the tree. Second, future share prices are translated into option values at each node of the tree. Third, these future option values are discounted and added to produce a single present value of the option, taking into account the probabilities of each series of price moves in the model.

#### Example—Multiperiod option valuation using the binomial model

Consider the following example of a two-period binomial model. Again, certain simplifying assumptions will be made so that a manual calculation can be illustrated (in general, computer programs will be necessary to compute option values). Eager Corp. grants 10,000 options to its employees at a time when the market price of shares is €40. The options expire in two years; expected dividends on the shares will be €0.50 per year; and the risk-free rate is currently 3%, which is not expected to change over the two-year horizon. The option exercise price is €43.

The entity's past experience suggests that, after one year (of the two-year term) elapses, if the market price of the share exceeds the option exercise price, one-half of the options will be exercised by the holders. The other holders will wait another year to decide. If at the end of the second year—without regard to what the share value was at the end of the first year—the market value exceeds

the exercise price, all the remaining options will be exercised. The workforce has been unusually stable and it is not anticipated that option holders will cease employment before the end of the option period.

The share price moves randomly from period to period. Based on recent experience, it is anticipated that in each period the shares may increase by €5, stay the same, or decrease by €5, with equal probability, versus the price at the period year-end. Thus since the price is €40 at grant date, one year hence it might be €45, €40 or €35. The price at the end of the second year will follow the same pattern, based on the price when the first year ends.

Logically, holders will rather exercise their options than see them expire, as long as there is gain to be realized. Since dividends are not paid on options, holders have a motive to exercise earlier than the expiration date, which explains why historically one-half the options are exercised after one year elapses, as long as the market price exceeds the exercise price at that date, even though the exercising holders risk future market declines.

The binomial model formulation requires that each sequence of events and actions be explained. This gives rise to the commonly seen decision tree representation. In this simple example, following the grant of the options, one of three possible events occurs: the share price rises €5 over the next year, or it remains constant, or it falls by €5. Since these outcomes have equal a priori probabilities,  $p=1/3$  is assigned to each outcome of this first year event. If the price does rise, one-half the option holders will exercise at the end of the first year, to reap the economic gain and capture the second year's dividend. The other holders will forego this immediate gain and wait to see what the share price does in the second year before making an exercise decision.

If the share price in the first year either remains flat or falls by €5, no option holders are expected to exercise. However, there remains the opportunity to exercise after the second year elapses, if the share price recovers. Of course, holding the options for the second year means that no dividends will be received.

The cost of the options granted by Eager Corp., measured by fair value using the binomial model approach is computed by the sum of the probability-weighted outcomes, discounted to present value using the risk-free rate. In this example, the rate is expected to remain at 3% per year throughout the option period, but it could be independently specified for each period—another advantage the binomial model has over the more rigid BSM. The sum of these present value computations measures the cost of compensation incorporated in the option grant, regardless of what pattern of exercise ultimately is revealed, since at the grant date, using the available information about share price volatility, expected dividends, exercise behaviour and the risk-free rate, this best measures the value of what was promised to the employees.

The following graphic offers a visual representation of the model, although in practice it is not necessary to prepare such a document. The actual calculations can be made by computer program, but to illustrate the application of the binomial model, the computation will be presented explicitly here. There are four possible scenarios under which, in this example, holders will exercise the options, and thus the options will have value. All other scenarios (combinations of share price movements over the two-year horizon) will cause the holders to allow the options to expire unexercised.

First, if the share price goes to €45 in the first year, one-half the holders will exercise at that point, paying the exercise price of €43 per share. This results in a gain of €2 (= €45 – €43) per share. However, having waited until the first year-end, they lost the opportunity to receive the €0.50 per share dividend, so the net economic gain is only €1.50 (= €2.00 – €0.50) per share. As this occurs after one year, the present value is only  $€1.50 \times 1.03^{-1} = €1.46$  per share. When this is weighted by the probability of this outcome obtaining (given that the share price rise to €45 in the first year has only a 1/3 probability of happening, and given further that only one-half the option holders would elect to exercise under such conditions), the actual expected value of this outcome is  $[(1/3)(1/2)$

(€1.46) =] €0.24. More formally,

$$[(1/3)(1/2)(€2.00 - €0.50)] \times 1.03^{-1} = €0.2427$$

The second potentially favourable outcome to holders would be if the share price rises to €45 the first year and then either rises another €5 the second year or holds steady at €45 during the second year. In either event, the option holders who did not exercise after the first year's share price rise will all exercise at the end of the second year, before the options expire. If the price goes to €50 the second year, the holders will reap a gross gain of €7 (=€50 - €43) per share; if it remains constant at €45, the gross gain is only €2 per share. In either case, dividends in both years one and two will have been foregone. To calculate the compensation cost associated with these branches of the model, the first-year dividend lost must be discounted for one year, and the gross gain and the second-year dividend must be discounted for two years. Also, the probabilities of the entire sequence of events must be used, taking into account the likelihood of the first year's share price rise, the proclivity of holders to wait for a second year to elapse, and the likelihood of a second-year price rise or price stability. These computations are shown below.

For the outcome if the share price rises again

$$\begin{aligned} & [(1/3)(1/2)(1/3)]\{[(€7.00) \times 1.03^{-2}] - [(€0.50) \times 1.03^{-1}] - [€0.50 \times 1.03^{-2}]\} \\ & = [0.05544]\{€6.59 - €0.48 - €0.47\} = €0.31276 \end{aligned}$$

For the outcome if the share price remains stable

$$\begin{aligned} & [(1/3)(1/2)(1/3)]\{[(€2.00) \times 1.03^{-2}] - [(€0.50) \times 1.03^{-1}] - [€0.50 \times 1.03^{-2}]\} \\ & = [0.05544]\{€1.88 - €0.48 - €0.47\} = €0.05147 \end{aligned}$$

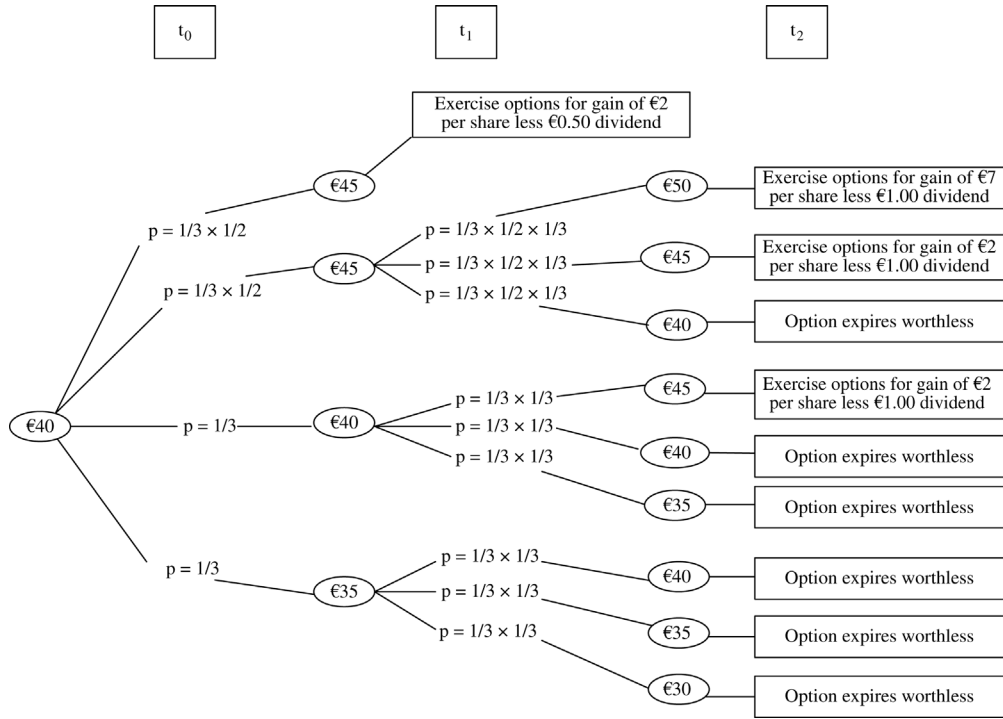
The final favourable outcome for holders would occur if the share price holds constant at €40 the first year but rises to €45 the second year, making exercise the right decision. Note that none of the holders would exercise after the first year given that the price, €40, was below exercise price. The calculation for this sequence of events is as follows:

$$\begin{aligned} & [(1/3)(1/3)]\{[(€2.00) \times 1.03^{-2}] - [(€0.50) \times 1.03^{-1}] - [€0.50 \times 1.03^{-2}]\} \\ & = [0.1111]\{€1.88 - €0.48 - €0.47\} = €0.10295 \end{aligned}$$

Summing these values yields €0.709879 (€0.2427 + €0.31276 + €0.05147 + €0.10295), which is the expected value per option granted. When this per-unit value is then multiplied by the number of options granted, 10,000, the total compensation cost to be recognized, €7,098.79, is derived. This would be attributed over the required service period, which is illustrated later in this section. (In the facts of this example, no vesting requirements were specified; in such cases, the employees would not have to provide future service in order to earn the right to the options, and the entire cost would be recognized upon grant.)

A big advantage of the binomial model is that it can value an option that is exercisable before the end of its term (i.e., an American-style option). This is the form that employee share-based compensation arrangements normally take. IASB appears to recognize the virtues of the binomial type of model, because it can incorporate the unique features of employee share options. Two key features that should generally be incorporated into the binomial model are vesting restrictions and early exercise. Doing so, however, requires that the reporting entity will have had previous experience with employee behaviours (e.g., gained

with past employee option programs) that would provide it with a basis for making estimates of future behaviour. In some instances, there will be no obvious bases upon which such assumptions can be developed.



The binomial model permits the specification of more assumptions than does the BSM, which has generated the perception that the binomial will more readily be manipulated so as to result in lower option values, and hence lower compensation costs, when contrasted to the BSM. But, this is not necessarily the case: switching from BSM to the binomial model can increase, maintain or decrease the option's value. Having the ability to specify additional parameters, however, does probably give management greater flexibility and, accordingly, will present additional challenges for the auditors who must attest to the financial statement effects of management's specification of these variables.

Historically, it has long been recognized that prudence would normally necessitate the recognition of even uncertain liabilities, while uncertain assets were not to be recognized. IAS 37, the key standard on provisions, addresses the boundaries of recognition.

The recognition and measurement of provisions can have a major impact on the way in which the financial position of an entity is viewed. IAS 37 addresses so-called “onerous contract” provisions, which require a company to take into current earnings the entire cost of fulfilling contracts that continue into the future under defined conditions. This can be a very sensitive issue for a company experiencing trading difficulties.

Another sensitive issue is the accounting for decommissioning or similar asset retirement costs, which increasingly are becoming a burden for companies engaged in mineral extraction and manufacturing, but also potentially for those engaged in agriculture and other industry segments. Where historically it was assumed that these costs were future events to be recognized in later periods, it is now clear that these are costs of asset ownership and operation that need to be reflected over the productive lives of the assets, and that the estimated costs are to be recognized as a formal obligation of the reporting entity.

The reporting entity’s financial position may also be affected by events, both favourable and unfavourable, which occur between the end of the reporting period and the date when the financial statements are authorized for issue. Under IAS 10, such events require either formal recognition in the financial statements or only disclosure, depending on the character and timing of the event in question, which are referred to as “adjusting” and “non-adjusting,” respectively.

In practice, there may be some ambiguity as to when the financial statements are actually “authorized for issuance.” For this reason, the standard recognizes that the process involved in authorizing the financial statements for issue will vary and may be dependent upon the reporting entity’s management structure, statutory requirements and the procedures prescribed for the preparing and finalizing of the financial statements. Thus, IAS 10 illustrates in detail the principles governing the determination of the financial statements’ authorization date, which date is required to be disclosed.

<i>IAS</i> 1, 10, 37, 39	<b>Sources of IFRS</b>	<i>IFRIC</i> 1, 6, 21
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## DEFINITIONS OF TERMS

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**Adjusting events after the reporting period.** Those events after the reporting period that provide evidence of conditions that existed at the end of the reporting period and require that the financial statements be adjusted.

**Authorization date.** The date when the financial statements would be considered legally authorized for issue.

**Constructive obligation.** An obligation resulting from an entity’s actions such that the entity:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, has indicated to third parties that it will accept certain responsibilities; and
- As a result, has created a valid expectation in the minds of third parties that it will discharge those responsibilities.

**Contingent asset.** A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the reporting entity.

**Contingent liability.** An obligation that is either:

- A possible obligation arising from past events, the outcome of which will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events which are not wholly within the control of the reporting entity; or
- A present obligation arising from past events which is not recognized either because it is not probable that an outflow of resources will be required to settle an obligation, or where the amount of the obligation cannot be measured with sufficient reliability.

**Current liabilities.** A liability of the entity which:

- The entity expects to settle in its normal operating cycle; or
- The entity holds primarily for the purpose of trading; or
- Is due to be settled within 12 months after the reporting period; or
- Does not allow the entity an unconditional right to defer settlement thereof for at least 12 months after the reporting period.

**Events after the reporting period.** Events, favourable and unfavourable, that occur between the entity's end of the reporting period and the date the financial statements are authorized for issue that would necessitate either adjusting the financial statements or disclosure. These include adjusting events and non-adjusting events.

**Legal obligation.** An obligation that derives from the explicit or implicit terms of a contract, or from legislation or other operation of law.

**Levy.** An outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (i.e. laws and/or regulations), other than:

- a. Outflows of resources that are within the scope of other standards (such as income taxes that are within the scope of IAS 12, *Income Taxes*); and
- b. Fines or other penalties that are imposed for breaches of the legislation.

**Liability.** 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.

**Non-adjusting events after the reporting period.** Those events after the reporting period that provide evidence of conditions that arose *after* the end of the reporting period and which thus would *not* necessitate adjusting financial statements. Instead, if significant, these would require disclosure.

**Obligating event.** An event that creates a legal or constructive obligation that results in an entity having no realistic alternative but to settle that obligation.

**Onerous contract.** A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received therefrom.

**Operating cycle.** The operating cycle of an entity is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be 12 months.

**Provision.** Liabilities having uncertain timing or amount.

**Restructuring.** A program that is planned and controlled by management and which materially changes either the scope of business undertaken by the entity or the manner in which it is conducted.

## RECOGNITION AND MEASUREMENT

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### Current Liabilities

#### *Classification*

IAS 1 requires that the reporting entity must present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its statement of financial position, except when a liquidity presentation provides more relevant and reliable information. In those exceptional instances, all assets and liabilities are to be presented broadly in order of liquidity. Whether classified or employing the order of liquidity approach, for any asset or liability reported as a discrete line item that combines amounts expected to be realized or settled within no more than 12 months after the reporting period and more than 12 months after the reporting period, the reporting entity must disclose the amount expected to be recovered or settled after more than 12 months.

IAS 1 also makes explicit reference to the requirements imposed by IAS 32 concerning financial assets and financial liabilities. Since such common items in the statement of financial position as trade and other receivables and payables are within the definition of financial instruments, information about maturity dates is already required under IFRS. While most trade payables and accrued liabilities will be due within 30 to 90 days, and thus are understood by all financial statement readers to be current, this requirement would necessitate additional disclosure, either in the statement of financial position or in the footnotes thereto, when this assumption is not warranted.

The other purpose of presenting a classified statement of financial position is to highlight those assets and obligations that are “continuously circulating” in the phraseology of IAS 1. That is, the goal is to identify specifically resources and commitments that are consumed or settled in the normal course of the operating cycle. In some types of businesses, such as certain construction entities, the normal operating cycle may exceed one year. Thus, some assets or liabilities might fail to be incorporated into a definition based on the first goal of reporting, providing insight into liquidity, but be included in one that meets the second goal.

As a compromise, if a classified statement of financial position is indeed being presented, the convention for financial reporting purposes is to consider assets and liabilities current if they will be realized and settled within one year or one operating cycle, whichever is longer. Since this may vary in practice from one reporting entity to another, however, it is important for users to read the accounting policies set forth in notes to the financial statements. The classification criterion should be set forth there, particularly if it is other than the rule most commonly employed: one-year threshold.

#### *Nature of current liabilities*

Current liabilities are generally perceived to be those that are payable within 12 months of reporting date. The convention has long been to use one year after the reporting period as the threshold for categorization as current, subject to the operating cycle issue for liabilities linked to operations. Examples of liabilities which are not expected to be settled in the normal course of the operating cycle but which, if due within 12 months would be deemed current, are current portions of long-term debt and bank overdrafts, dividends declared and payable, and various non-trade payables.

Current liabilities would almost always include not only obligations that are due on demand (typically including bank lines of credit, other demand notes payable, and certain

overdue obligations for which forbearance has been granted on a day-to-day basis), but also the currently scheduled payments on longer-term obligations, such as installment agreements. Also included in this group would be trade credit and accrued expenses, and deferred revenues and advances from customers for which services are to be provided or product delivered within one year. If certain conditions are met (described below), short-term obligations that are intended to be refinanced may be excluded from current liabilities. An amendment to IAS 1, effective January 1, 2009, clarifies that terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification. For example, if a liability to be settled in full in cash after five years also allows the lender to demand settlement in shares of the borrower at any point prior to the settlement date, that liability will be classified as non-current.

Like all liabilities, current liabilities may be known with certainty as to amount, due date and payee, as is most commonly the case. However, one or more of these elements may be unknown or subject to estimation. Consistent with basic principles of accrual accounting, however, the lack of specific information on, say, the amount owed, will not serve to justify a failure to record and report on such obligations. The former commonly used term “estimated liabilities” has been superseded per IAS 37 by the term “provisions.” Provisions and contingent liabilities are discussed in detail later in this chapter.

### *Offsetting current assets against related current liabilities*

IAS 1 states that current liabilities are not to be reduced by the deduction of a current asset (or vice versa) unless required or permitted by another IFRS. In practice, there are few circumstances that would meet this requirement; certain financial instruments (to the extent permitted by IAS 32) are the most commonly encountered exceptions. As an almost universal rule, therefore, assets and liabilities must be shown “gross,” even where the same counterparties are present (e.g., amounts due from and amounts owed to another entity).

### *Types of liabilities*

Current obligations can be divided into those where:

1. Both the amount and the payee are known;
2. The payee is known but the amount may have to be estimated;
3. The payee is unknown and the amount may have to be estimated; and
4. The liability has been incurred due to a loss contingency.

These types of liabilities are discussed in the following sections.

### **Amount and Payee Known**

**Accounts payable** arise primarily from the acquisition of materials and supplies to be used in the production of goods or in conjunction with providing services. Payables that arise from transactions with suppliers in the normal course of business, which customarily are due in no more than one year, may be stated at their face amount rather than at the present value of the required future cash flows if the effect of discounting is immaterial.

**Notes payable** are more formalized obligations that may arise from the acquisition of materials and supplies used in operations or from the use of short-term credit to purchase capital assets. Monetary obligations, other than those due currently, should be presented at the present value of future payments, thus giving explicit recognition to the time value of



money. Discounting, however, is only required where the impact of the discounting would be material on the financial statements. In many cases, the discounting of short-term obligations would not be material. (Note that if the obligations are interest-bearing at a reasonable rate determined at inception, discounting is not an issue.)

**Dividends payable** become a liability of the entity when a dividend has been approved. However, jurisdictions vary as to how this is interpreted. Under most continental European company law, only the shareholders in general meeting can approve a dividend, and so the function of the directors is to propose a dividend, which itself does not give rise to a liability. In other jurisdictions, the decision of the board of directors would trigger recognition of a liability. Since declared dividends are usually paid within a short period of time after the declaration date, they are classified as current liabilities, should a statement of financial position be prepared at a date between the two events.

**Unearned revenues or advances** result from customer prepayments for either performance of services or delivery of product. They may be required by the selling entity as a condition of the sale or may be made by the buyer as a means of guaranteeing that the seller will perform the desired service or deliver the product. Unearned revenues and advances should be classified as current liabilities at the end of the reporting period if the services are to be performed or the products are to be delivered within one year or the operating cycle, whichever is longer.

**Returnable deposits** may be received to cover possible future damage to property. Many utility companies require security deposits. A deposit may be required for the use of a reusable container. Refundable deposits are classified as current liabilities if the entity expects to refund them during the current operating cycle or within one year, whichever is longer.

**Accrued liabilities** have their origin in the end-of-period adjustment process required by accrual accounting. They represent economic obligations, even when the legal or contractual commitment to pay has not yet been triggered. Commonly accrued liabilities include wages and salaries payable, interest payable, rent payable and taxes payable.

**Agency liabilities** result from the legal obligation of the entity to act as the collection agent for employee or customer taxes owed to various federal, state or local government units. Examples of agency liabilities include value-added tax, sales taxes, income taxes withheld from employee salaries, and employee social security contributions, where mandated by law. In addition to agency liabilities, an employer may have a current obligation for unemployment taxes. Payroll taxes typically are not legal liabilities until the associated payroll is actually paid, but in keeping with the concept of accrual accounting, if the payroll has been accrued, the associated payroll taxes should be as well.

**Obligations** that are, by their terms, due on demand or will become due on demand within one year (or operating cycle, if longer) from the end of the reporting period, even if liquidation is not expected to occur within that period, must be classified as current liabilities.

However, when the reporting entity breaches an undertaking or covenant under a long-term loan agreement, thereby causing the liability to become due and payable on demand, it must be classified as current at the end of the reporting period, even if the lender has agreed, after the end of the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach (i.e., to give forbearance to the borrower).

On the other hand, if the lender has granted an extension before the end of the reporting period (extending for at least one year from the end of the reporting period), then non-current classification would be warranted. Similarly, if the lender has agreed by the end of the reporting period to provide a grace period within which the entity can rectify a breach of an

undertaking or covenant under a long-term loan agreement and during that time the lender cannot demand immediate repayment, the liability is to be classified as non-current if it is due for settlement, without that breach of an undertaking or covenant, at least 12 months after the reporting period *and either*.

1. The entity rectifies the breach within the period of grace; *or*
2. When the financial statements are authorized for issue, the grace period is incomplete and it is probable that the breach will indeed be rectified.

Failure to rectify the breach confirms that current classification of the liability was warranted, and the financial statements would be adjusted to conform to that fact.

### ***Short-term obligations expected to be refinanced***

Long-term financial liabilities within 12 months of maturity are current liabilities in a classified statement of financial position. In some cases, the reporting entity has plans or intentions to refinance the debt (to “roll it over”) and thus does not expect its maturity to cause it to deploy its working capital. Under provisions of IAS 1, this debt must be shown as current when due to be settled within 12 months of the end of the reporting period, notwithstanding that its original term was for a period of more than 12 months; and that an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorized for issuance.

However, if the reporting entity has the ability, unilaterally, to refinance or “roll over” the debt for at least 12 months after the end of the reporting period, under the terms of an existing loan facility, it is classified as non-current, even if it is otherwise due to be repaid within 12 months of the end of the reporting period, if a “rollover” is the entity’s intent. This differs from the situation in which refinancing or “rolling over” the obligation is not at the discretion of the entity (as when there is no agreement to refinance), in which case the potential to refinance (which is no more than the borrower’s hope in such instance) is not considered and the obligation is classified as current.

#### **Example of short-term obligations to be refinanced**

The Marrakech Warehousing Company has obtained a €3,500,000 bridge loan to assist it in completing a new warehouse. All construction is completed by the end of the reporting period, after which Marrakech has the following three choices for refinancing the bridge loan:

- Enter into a 30-year fixed-rate mortgage for €3,400,000 at 7% interest, leaving Marrakech with a €100,000 obligation to fulfill from short-term funds. Under this scenario, Marrakech reports as current debt the €100,000, as well as the €50,000 portion of the mortgage due within one year, with the remainder of the mortgage itemized as long-term debt. The presentation follows:

#### *Current liabilities*

Short-term notes	100,000
Current portion of long-term debt	50,000

#### *Non-current liabilities*

7% mortgage note due in full by 20XX+30	3,350,000
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- Pay off the bridge loan with Marrakech’s existing variable rate line of credit (LOC), which expires in two years. The maximum amount of the LOC is 80% of Marrakech’s accounts receivable. Over the two-year remaining term of the LOC, the lowest level of qualifying accounts receivable is expected to be €2,700,000. Thus only €2,700,000 of the debt can be

classified as long-term, while €800,000 is classified as a short-term obligation. The presentation follows:

*Current liabilities*

Short-term note—variable rate line of credit	800,000
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*Non-current liabilities*

Variable rate line of credit due in 20XX+2	2,700,000
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- Obtain a loan bearing interest at 10% from Marrakech’s owner, with a balloon payment due in five years. Under the terms of this arrangement, the owner can withdraw up to €1,500,000 of funding at any time, even though €3,500,000 is currently available to Marrakech. Under this approach, €1,500,000 is callable, and therefore must be classified as a short-term obligation. The remainder is classified as long-term debt. The presentation follows:

*Current liabilities*

Short-term note—majority stockholder	1,500,000
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*Non-current liabilities*

10% balloon note payable to majority stockholder, due in 20XX+5	2,000,000
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### ***Long-term debt subject to demand for repayment***

A lender may have the right to demand immediate or significantly accelerated repayment, or such acceleration rights vest with the lender upon the occurrence of certain events. For example, long-term (and even many short-term) debt agreements typically contain covenants, which effectively are negative or affirmative restrictions on the borrower as to undertaking further borrowings, paying dividends, maintaining specified levels of working capital and so forth. If a covenant is breached by the borrower, the lender will typically have the right to call the debt immediately, or to otherwise accelerate repayment.

In other cases, the lender will have certain rights under a “subjective acceleration clause” inserted into the loan agreement, giving it the right to demand repayment if it perceives that its risk position has deteriorated as a result of changes in the borrower’s business operations, liquidity or other sometimes vaguely defined factors. Obviously, this gives the lender great power and subjects the borrower to the real possibility that the nominally long-term debt will, in fact, be short-term.

IAS 1 addresses the matter of breach of loan covenants, but does not address the less common phenomenon of subjective acceleration clauses in loan agreements. As to the former, it provides that continued classification of the debt as non-current, when one or more of the stipulated default circumstances has occurred, is contingent upon meeting two conditions: First, the lender has agreed, prior to approval of the financial statements, not to demand payment as a consequence of the breach (giving what is known as a debt compliance waiver); and second, that it is considered not probable that further breaches will occur within 12 months of the end of the reporting period. If one or both of these cannot be met, the debt must be reclassified to current status if a classified statement of financial position is, as is generally required under IAS 1, to be presented.

Logic suggests that the existence of subjective acceleration clauses convert nominally long-term debt into currently payable debt as the entity does not have an unconditional right to defer payment for 12 months from year-end. Such debt should be shown as current, with sufficient disclosure to inform the reader that the debt could effectively be “rolled over” until the nominal maturity date, at the sole discretion of the lender.

## Payee Known but Amount May Need to Be Estimated

### Provisions

Under IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*, those liabilities for which amount or timing of expenditure is uncertain are deemed to be provisions.

IAS 37 provides a comprehensive definition of the term “provision.” It mandates, in a clear-cut manner, that a provision should be recognized *only* if:

- The entity has a present obligation (legal or constructive) as a result of a past event;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

Thus, a whole range of vaguely defined reserves found in financial statements in days past are clearly not permitted under IFRS. This includes the oft-manipulated restructuring reserves commonly found created during the business combination process. Now, unless there is a *present obligation* as of the purchase combination date, such reserves cannot be established—in most instances, any future restructuring costs will be recognized after the merger event and charged against the successor entity’s earnings.

Many other previously employed reserves are likewise barred by the strict conditions set forth by IAS 37. However, the mere need to estimate the amount to be reflected in the provision is not evidence of a failure to qualify for recognition. If an actual obligation exists, despite one or more factors making the amount less than precisely known, recognition is required.

IAS 37 offers in-depth guidance on the topic of provisions. Each of the key words in the definition of the term “provision” is explained in detail by the standard. Explanations and clarifications offered by the standard are summarized below.

- **Present obligation.** The standard states that in almost all cases it will be clear when a present obligation exists. The notion of an obligation in the standard includes not only a legal obligation (e.g., deriving from a contract or legislation) but also a constructive obligation. It explains that a constructive obligation exists when the entity from an established pattern of past practice or stated policy has created a valid expectation that it will accept certain responsibilities.
- **Past event.** There must be some past event which has triggered the present obligation—for example, an accidental oil spillage. An accounting provision cannot be created in anticipation of a future event. The entity must also have no realistic alternative to settling the obligation caused by the event. In other words, if the entity can avoid the expenditure through its own actions, a provision cannot be recognized (e.g., planned future maintenance on a plant).
- **Probable outflow of resources embodying economic benefits.** For a provision to qualify for recognition it is essential that it is not only a present obligation of the reporting entity, but also it should be probable that an outflow of resources embodying benefits used to settle the obligation will in fact result. For the purposes of this standard, probable is defined as “more likely than not.” A footnote to the standard states that this interpretation of the term “probable” does not necessarily apply to other IFRS. The use of terms such as probable, significant or impracticable creates problems of interpretation, both within a given set of standards (e.g., IFRS) and across different sets.

- **Reliable estimate of the obligation.** The standard recognizes that using estimates is common in the preparation of financial statements and suggests that by using a range of possible outcomes, an entity will usually be able to make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision. Where no reliable estimate can be made, though, no liability is recognized.

Other salient features of provisions explained by the standard include the following:

1. **Best estimate.** For all estimated liabilities that are included within the definition of provisions, the amount to be recorded and presented in the statement of financial position should be the *best estimate*, at the end of the reporting period, of the amount of expenditure that will be required to settle the obligation. This is often referred to as the “expected value” of the obligation, which may be operationally defined as the amount the entity would pay, currently, to either settle the actual obligation or provide consideration to a third party to assume it (e.g., as a single occurrence insurance premium). For estimated liabilities comprised of large numbers of relatively small, similar items, weighting by probability of occurrence can be used to compute the aggregate expected value; this is often used to compute accrued warranty reserves, for example. For those estimated liabilities consisting of only a few (or a single) discrete obligations, the most likely outcome may be used to measure the liability when there is a range of outcomes having roughly similar probabilities; but if possible outcomes include amounts much greater (and lesser) than the most likely, it may be necessary to accrue a larger or lesser amount if there is a significant chance that the larger or lower obligation will have to be settled, even if that is not the most likely outcome as such.

The concept of “expected value” can be best explained through an example:

Good Samaritan Inc. manufactures and sells pinball machines under warranty. Customers are entitled to refunds if they return defective machines with valid proof of purchase. Good Samaritan Inc. estimates that if all machines sold and still in warranty had major defects, total replacement costs would equal €1,000,000; if all those machines suffered from minor defects, the total repair costs would be €500,000. Good Samaritan’s past experience, however, suggests that only 10% of the machines sold will have major defects, and that another 30% will have minor defects. Based on this information, the expected value of the product warranty costs to be accrued at year-end would be computed as follows:

<b>Expected value of the cost of refunds:</b>		
Resulting from major defects:	$€1,000,000 \times 0.10 =$	€100,000
Resulting from minor defects:	$€ 500,000 \times 0.30 =$	150,000
No defects:	$€ 0 \times 0.60 =$	--
	Total =	<u>€250,000</u>

2. **Risks and uncertainties.** The “risks and uncertainties” surrounding events and circumstances should be taken into account in arriving at the best estimate of a provision. However, as pointedly noted by the standard, uncertainty should not be used to justify the creation of excessive provisions or a deliberate overstatement of liabilities.
3. **Discounting.** The standard also addresses the use of present values or discounting (i.e., recording the estimated liability at present value, after taking into account the time

value of money). While the entire subject of present value measurement in accounting has been widely debated, in practice there is a notable lack of consistency (with some standards requiring it, others prohibiting it, and many others remaining silent on the issue). IAS 37 has stood firm on the subject of present value measurement and requires the use of discounting when the effect would be material, but it can be ignored if immaterial in effect. Thus, provisions estimated to be due farther into the future will have more need to be discounted than those due currently. As a practical matter, all but trivial provisions should be discounted unless the timing is unknown (which makes discounting a computational impossibility).

IAS 37 clarifies that the discount rate applied should be consistent with the estimation of cash flows (i.e., if cash flows are projected in nominal terms). That is, if the estimated amount expected to be paid out reflects whatever price inflation is anticipated to occur between the end of the reporting period and the date of ultimate settlement of the estimated obligation, then a nominal discount rate should be used. If future cash outflows are projected in real terms, net of any price inflation, then a real interest rate should be applied. In either case, past experience must be used to ascertain likely timing of future cash flows, since discounting cannot otherwise be performed.

4. **Future events.** Future events that may affect the amount required to settle an obligation should be reflected in the provision amount where there is sufficient objective evidence that such future events will in fact occur. For example, if an entity believes that the cost of cleaning up a plant site at the end of its useful life will be reduced by future changes in technology, the amount recognized as a provision for cleanup costs should reflect a reasonable estimate of cost reduction resulting from any anticipated technological changes. However, in many instances making such estimates will not be possible.
5. **Decommissioning provisions.** IFRIC 1 mandates that changes in decommissioning provisions should be recognized prospectively (i.e., by amending future depreciation charges).
6. **Disposal proceeds.** Gains from expected disposals of assets should not be taken into account in arriving at the amount of the provision (even if the expected disposal is closely linked to the event giving rise to the provision).
7. **Reimbursements.** Reimbursements by other parties should be taken into account when computing the provision, only if it is virtually certain that the reimbursement will be received. The reimbursement should be treated as a separate asset on the statement of financial position, and not netted against the estimated liability. However, in the statement of comprehensive income the provision may be presented net of the amount recognized as a reimbursement. In the authors' observation, recognition of such contingent assets would be very rare in practice due to the long time horizons and concerns about the viability of the parties promising to make reimbursement payments over the long term.
8. **Changes in provisions.** Changes in provisions should be considered at the end of each reporting period, and provisions should be adjusted to reflect the current best estimate. If upon review it appears that it is no longer probable that an outflow of resources embodying economics will be required to settle the obligation, then the provision should be reversed through current period profit or loss as a change in estimate.



9. **Use of provisions recognized.** Use of a provision is to be restricted to the purpose for which it was recognized originally. A reserve for plant dismantlement, for example, cannot be used to absorb environmental pollution claims or warranty payments. If an expenditure is set against a provision that was originally recognized for another purpose, that would camouflage the impact of the two different events, distorting income performance and possibly constituting financial reporting fraud.
10. **Future operating losses.** Provisions for future operating losses cannot be recognized. This is explicitly proscribed by the standard, since future operating losses do not meet the definition of a liability at the end of the reporting period (as defined in the standard) and the general recognition criteria set forth in the standard.
11. **Onerous contracts.** Present obligations under *onerous contracts* should be recognized and measured as a provision. The standard introduces the concept of onerous contracts, which it defines as contracts under which the unavoidable costs of satisfying the obligations exceed the economic benefits expected. Executory contracts that are not onerous do not fall within the scope of this standard. In other words, the expected negative implications of such contracts (executory contracts which are not onerous) cannot be recognized as a provision.  
The standard mandates that unavoidable costs under a contract represent the “least net costs of exiting from the contract.” Such unavoidable costs should be measured at the *lower of*
  - The cost of fulfilling the contract; *or*
  - Any compensation or penalties arising from failure to fulfill the contract.
12. **Restructuring provisions.** Provisions for restructuring costs are recognized only when the general recognition criteria for provisions are met. A constructive obligation to restructure arises only when an entity has a *detailed formal plan* for the restructuring which identifies at least the following:
  - The business or the part of the business concerned;
  - Principal locations affected;
  - Approximate number of employees that would need to be compensated for termination resulting from the restructuring (along with their function and location);
  - Expenditure that would be required to carry out the restructuring; and
  - Information as to when the plan is to be implemented.

Furthermore, the recognition criteria also require that the entity should have raised a valid expectation among those affected by the restructuring that it will, in fact, carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. Thus, until all the conditions mentioned above are satisfied, a restructuring provision cannot be made based upon the concept of constructive obligation. In practice, given the strict criteria of IAS 37, restructuring costs are more likely to become recognizable when actually incurred in a subsequent period.

Only *direct* expenditures arising from restructuring should be provided for. Such direct expenditures should be both necessarily incurred for the restructuring *and* not associated with the ongoing activities of the entity. Thus, a provision for restructuring would not include costs like: cost of retraining or relocating the entity’s current staff members or costs of marketing or investments in new systems and distribution

networks (such expenditures are in fact categorically disallowed by the standard, as they are considered to be expenses relating to the future conduct of the business of the entity, and thus are not liabilities relating to the restructuring program). Also, identifiable future operating losses up to the date of an actual restructuring are not to be included in the provision for a restructuring (unless they relate to an onerous contract). Furthermore, in keeping with the general measurement principles relating to provisions outlined in the standard, the specific guidance in IAS 37 relating to restructuring prohibits taking into account any gains on expected disposal of assets in measuring a restructuring provision, even if the sale of the assets is envisaged as part of the restructuring.

A management decision or a board resolution to restructure taken before the end of the reporting period does not automatically give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period: either started to implement the restructuring plan, or announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner such that a valid expectation is raised in them (i.e., that the entity will in fact carry out the restructuring and that benefits will be paid to them).

Examples of events that may fall within the definition of restructuring are:

- A fundamental reorganization of an entity that has a material effect on the nature and focus of the entity's operations;
- Drastic changes in the management structure—for example, making all functional units autonomous;
- Removing the business to a more strategic location or place by relocating the headquarters from one country or region to another; and
- The sale or termination of a line of business (if certain other conditions are satisfied, such that a restructuring could be considered a discontinued operation under IFRS 5).

## DISCLOSURES

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Disclosures mandated by the standard for provisions are the following:

- For each class of provision, the carrying amount at the beginning and the end of the period, additional provisions made during the period, amounts used during the period, unused amounts reversed during the period, and the increase during the period in the discounted amount arising from the passage of time and the effect of change in discount rate (comparative information is not required).
- For each class of provision, a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits, an indication of the uncertainties regarding the amount or timing of those outflows (including, where necessary in order to provide adequate information, disclosure of major assumptions made concerning future events), and the amount of any expected reimbursement, stating the amount of the asset that has been recognized for that expected reimbursement.
- In extremely rare circumstances, if the above disclosures as envisaged by the standard are expected to seriously prejudice the position of the reporting entity in a dispute with third parties on the subject matter of the provision, then the standard takes a lenient view and allows the reporting entity to disclose the general nature of the



dispute together with the fact that, and reason why, the information has not been disclosed. This is to satisfy the concerns of those who believe that mere disclosure of certain provisions will encourage potential claimants to assert themselves, thus becoming a “self-fulfilling prophecy.”

For the purposes of making the above disclosures, it may be essential to group or aggregate provisions. The standard also offers guidance on how to determine which provisions may be aggregated to form a class. As per the standard, in determining which provisions may be aggregated to report as a class, the nature of the items should be sufficiently similar for them to be aggregated together and reported as a class. For example, while it may be appropriate to aggregate into a single class all provisions relating to warranties of different products, it may not be appropriate to group and present, as a single class, amounts relating to normal warranties and amounts that are subject to legal proceedings.

**Example footnote illustrating disclosures required under IAS 37 with respect to provisions**

	Model Disclosure Provisions			Total	IAS37 p84
	Environmental costs	Restructuring costs	Decommissioning costs		
Balance at 1 January 20XX	X	X	X	X	
Additional provision	X	X	X	X	
Amounts used	X	X	X	X	
Unused amounts reversed	X	X	X	X	
Unwinding of the discount	X	X	X	X	
<b>Balance at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	
Non-current provisions	X	X	X	X	IAS1 p60
Current provisions	X	X	X	X	

**Provision for environmental costs.** Statutory decontamination costs relating to old chemical manufacturing sites are determined based on periodic assessments undertaken by environmental specialists employed by the company and verified by independent experts.

**Provision for restructuring costs.** Restructuring provisions arise from a fundamental reorganization of the company’s operations and management structure.

**Provision for decommissioning costs.** Provision is made for estimated decommissioning costs relating to oilfields operated by the company based on engineering estimates and independent experts’ reports.

## PRACTICAL EXAMPLES

The following paragraphs provide examples of provisions that would need to be recognized, based on the rules laid down by the standard. It also discusses common provisions and the accounting treatment that is often applied to these particular items.

### ***Dry-docking costs***

In some countries it is required by law, for the purposes of obtaining a certificate of seaworthiness, that ships must periodically (e.g., every three to five years) undergo extensive repairs and incur maintenance costs that are customarily referred to as “dry-docking costs.” Depending on the type of vessel and its remaining useful life, such costs could be significant in amount. Before IAS 37 came into effect, some argued that dry-docking costs should be periodically accrued (in anticipation) and amortized over a period of time such that the amount is spread over the period commencing from the date of accrual to the date of payment. Using this approach, if every three years a vessel has to be dry-docked at a cost of €5 million, then such costs could be recognized as a provision at the beginning of each triennial period and amortized over the following three years.

Under the requirements set forth by IAS 37, provisions for future dry-docking expenditures cannot be accrued, since these future costs are not contractual in nature and can be avoided (e.g., by disposing of the vessel prior to its next overhaul). In general, such costs are to be expensed when incurred. However, consistent with IAS 16, if a separate component of the asset cost was recognized at inception (e.g., at acquisition of the vessel) and depreciated over its (shorter) useful life, then the cost associated with the subsequent dry-docking can likewise be capitalized as a separate asset component and depreciated over the interval until the next expected dry-docking. While the presumption is that this asset component would be included in the property and equipment accounts, in practice, some entities record major inspection or overhaul costs as a deferred charge (a non-current prepaid expense account) and amortize them over the expected period of benefit, which has the same impact on total assets and periodic results of operations.

### ***Unlawful environmental damage***

Cleanup costs and penalties resulting from unlawful environmental damage (e.g., an oil spill by a tanker ship which contaminates the water near the seaport) would need to be provided for in those countries which have laws requiring cleanup, since it would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.

In case the entity which has caused the environmental damage operates in a country that has not yet enacted legislation requiring cleanup, in some cases a provision may still be required based on the principle of constructive obligation (as opposed to a legal obligation). This may be possible if the entity has a widely publicized environmental policy in which it undertakes to clean up all contamination that it causes and the entity has a clean track record of honouring its published environmental policy. The reason a provision would be needed under the second situation is that the recognition criteria have been met—that is, there is a present obligation resulting from a past obligating event (the oil spill) and the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up the contamination (a constructive obligation) and the outflow of resources embodying economic benefits is probable.

The issue of determining what constitutes an “obligating event” under IAS 37 has been addressed, in a highly particularized setting, by IFRIC 6, *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*. This was in response to a European Union Directive on Waste Electrical and Electronic Equipment (WE&EE), which regulates the collection, treatment, recovery and environmentally sound

disposal of waste equipment. Such items contain toxic metals and other materials and have become a concern in recent years, due to the large quantities (e.g., obsolete computers) of goods being dumped by household and business consumers.

The EU Directive deals only with private household WE&EE sold before August 13, 2005 (“historical household equipment”). Assuming enactment of legislation by member states, it is to be mandated that the cost of waste management for this historical household equipment will be borne by the producers of that type of equipment, with levies being assessed on them in proportion to their market shares. This will be done with reference to those manufacturers that are in the market during a period to be specified in the applicable legislation of each EU member state (the “measurement period”).

The accounting issue is simply this: what is the obligating event that creates the liabilities for these producers of the defined historical household equipment, which of course all has already been sold by the producers in months and years gone by. IFRIC 6 concludes that it is participation in the market during the measurement period that will be the obligating event, rather than the earlier event (manufacture of the equipment) or a later event (incurment of costs in the performance of waste management activities). Accordingly, initial recognition of the liability will occur when the measurement period occurs.

While IFRIC 6 was promulgated in response to a specific, and unusual, situation, it does well illustrate how significant making such determinations (the obligating event, in this instance) can be with regard to presentation in the financial statements.

#### ***Provision for restructuring costs***

An entity which publicly announces, before the end of the reporting period, its plans to shut down a division in accordance with a board decision and a detailed formal plan, would need to recognize a provision for the best estimate of the costs of closing down the division. In such a case the recognition criteria are met as follows: a present obligation has resulted from a past obligating event (public announcement of the decision to the public at large) which gives rise to a constructive obligation from that date, since it creates a valid expectation that the division will be shut down and an outflow of resources embodying economic benefits in settlement is probable.

On the other hand, if the entity had not publicly announced its plans to shut down the division before the end of the reporting period, or did not start implementing its plan before the end of the reporting period, no provision would need to be made since the board decision alone would not give rise to a constructive obligation at the end of the reporting period (since no valid expectation has in fact been raised in those affected by the restructuring that the entity will start to implement that plan). When a reporting entity commences implementation of a restructuring plan, or announces its main features to those affected, only after the end of the reporting period, disclosure is required by the provisions of IAS 10. Applying the materiality logic common in financial reporting, such disclosure would only be mandatory if the restructuring is material and if non-disclosure could reasonably be expected to influence the economic decisions made by users on the basis of the financial statements.

#### ***Onerous contracts***

An entity relocates its offices to a more prestigious office complex because the old office building that it was occupying (and has been there for the last 20 years), does not suit the new

corporate image it wants to project. However, the lease of the old office premises cannot be canceled at the present time since it continues for the next five years. This is a case of an onerous contract wherein the unavoidable costs of meeting the obligations under the contract exceed the economic benefits under it. A provision is thus required to be made for the best estimate of unavoidable lease payments.

### ***Decommissioning costs***

An oil company installed an oil refinery on leased land. The installation was completed before the end of the reporting period. Upon expiration of the lease contract, seven years hence, the refinery will have to be relocated to another strategic location that would ensure uninterrupted supply of crude oil. These estimated relocation or decommissioning costs would need to be recognized at the end of the reporting period. Accordingly, a provision should be recognized for the present value of the estimated decommissioning costs to take place after seven years.

In 2004, the IASB's committee dealing with implementation issues (IFRIC) issued a final interpretation, IFRIC 1, *Changes in Decommissioning, Restoration and Similar Liabilities*, which provides further guidance on this topic. Specifically, this interpretation specifies how the following matters would be accounted for:

1. Changes in the estimated outflows of resources embodying economic benefits (e.g., cash flows) required to settle the obligation;
2. Changes in current market assessments of the discount rate as defined in IAS 37 (i.e., including changes in both the time value of money and the risks specific to the liability); and
3. Increases that reflect the passage of time (also referred to as the unwinding of the discount, or as accretion of the estimated liability amount).

The interpretation holds that, regarding changes in either the estimated future cash flows or in the assessed discount rate, these would be added to (or deducted from) the related asset to the extent the change relates to the portion of the asset that will be depreciated in future periods. These charges or credits will thereafter be reflected in periodic results of operations over future periods. Thus, no prior period adjustments will be permitted in respect to such changes in estimates, consistent with IAS 8.

Regarding accretion of the discount over the asset's useful life, so that the liability for decommissioning costs reaches full value at the date of decommissioning, the interpretation holds that this must be included in current income, presumably as a finance charge. Importantly, the interpretation states that this cannot be capitalized as part of the asset cost.

#### **Example of adjustment for changes in discount rate**

To illustrate the accounting for this change, assume an oil refinery was recorded inclusive of an estimated removal cost, at present value, of €2,333,000. Now assume that, after two years have elapsed, the relevant discount rate is assessed at 6%. There have been no changes in the estimated ultimate removal costs, which are still expected to total €4,000,000. The accreted recorded liability value at this date is €2,722,000, but given the new discount rate, it needs to be adjusted to €2,989,000, for an increase of €267,000 as of the beginning of the third year. The provision account must be credited by this amount, as shown in the journal entry below.

The asset account and accumulated depreciation must also be adjusted for this change in discount rate. Under the proposed requirement, this would be done by recomputing the amount that would have been capitalized, using the initial discount rate for the first two years, followed by the new discount rate over the remaining five years (note that the new rate is not imposed on the period already elapsed, because the rate originally used was correct during those earlier periods). If the €4,000,000 future value were discounted for five years at 6% and two years at 8%, the adjusted initial present value would have been €2,563,000, instead of the €2,333,000 actually recorded. To adjust for this, the asset must be increased by (€2,563,000 – €2,333,000 =) €230,000.

Had the revised present value of the removal costs been capitalized, €732,286 (= €2,563,000 × 2/7) would have been depreciated to date, instead of the €666,571 (= €2,333,000 × 2/7) that was in fact recorded, for a net difference in accumulated depreciation of €65,715. This amount must be credited to the contra asset account.

Asset	230,000	
Expense	102,715	
Accumulated depreciation		65,715
Decommissioning liability		267,000

The remaining part of the entry above, a debit to expense totaling €102,715, is the net effect of the increase in the net book value of the asset (€230,000 – €65,715 =) €164,285, offset by the increased provision, €267,000, which is an expense of the period.

**Bonus payments** may require estimation since the amount of the bonus payment may be affected by the amount of income taxes currently payable.

**Compensated absences** refer to paid vacation, paid holidays and paid sick leave. IAS 19 addresses this issue and requires that an employer should accrue a liability for employees' compensation of future absences if the employees' right to receive compensation for future absences is attributable to employee services already rendered, the right vests or accumulates, ultimate payment of the compensation is probable, and the amount of the payment can be reasonably estimated.

If an employer is required to compensate an employee for unused vacation, holidays or sick days, even if employment is terminated, the employee's right to this compensation is said to vest. Accrual of a liability for non-vesting rights depends on whether the unused rights expire at the end of the year in which earned or accumulated and are carried forward to succeeding years. If the rights expire, a liability for future absences should not be accrued at year-end because the benefits to be paid in subsequent years would not be attributable to employee services rendered in prior years. If unused rights accumulate and increase the benefits otherwise available in subsequent years, a liability should be accrued at year-end to the extent that it is probable that employees will be paid in subsequent years for the increased benefits attributable to the accumulated rights, and the amount can reasonably be estimated.

Pay for employee leaves of absence that represent time off for past services should be considered compensation subject to accrual. Pay for employee leaves of absence that will provide future benefits and that are not attributable to past services rendered would not be subject to accrual. Although in theory such accruals should be based on expected future rates of pay, as a practical matter these are often computed on current pay rates that may not materially differ and have the advantage of being known. Also, if the payments are to be made some time in the future, discounting of the accrual amounts

would seemingly be appropriate, but again this may not often be done for practical considerations.

Similar arguments can be made to support the accrual of an obligation for post-employment benefits other than pensions if employees' rights accumulate or vest, payment is probable and the amount can be reasonably estimated. If these benefits do not vest or accumulate, these would be deemed to be contingent liabilities. Contingent liabilities are discussed in IAS 37 and are considered later in this chapter.

### *Levies*

In May 2013, IFRIC issued a new interpretation, IFRIC 21, dealing with levies imposed by a government (or similar body) on an entity. The interpretation addresses the timing of recognition of such a levy that would be within the scope of IAS 37. The interpretation does not apply to liabilities in the scope of other standards, such as IAS 12, *Income Taxes*, nor does it apply to liabilities arising from commercial transactions between government and an entity. The interpretation also explicitly scopes out liabilities arising from emissions trading schemes, presumably since the emissions trading scheme project is still incomplete. The interpretation addresses six specific issues relating to the timing and recognition of levies, but does not address measurement of the liability arising from the levy. Once the levy meets the recognition criteria, measurement thereof is the same as for any other liability within the scope of IAS 37.

The first issue deals with identification of the obligating event. The interpretation concludes that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the relevant legislation.

The second issue clarifies that, although an entity may be compelled to continue to operate in a future period from an economic perspective, an entity claim to have a constructive obligation to pay a levy that will only be triggered by operating in a future period.

The third issue follows on from the second by confirming that an entity that asserts that it is a going concern does not have a present obligation to pay a levy that will only be triggered by operating in a future period.

The fourth issue deals with the timing of recognition of the liability—if the obligating event that gives rise to the levy occurs over a period of time (i.e., if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time), the levy would likewise be recognized as a liability over time. By implication then, if the obligating event occurs at a singular point in time, then the liability is also only recognized when that event occurs, which is consistent with the conclusion reached in issue one.

Some levies may only be payable once a minimum threshold of economic activity has been reached, such as a minimum level of sales during a particular period. The fifth issue reiterates that the previous principles established in the first four issues of the interpretation apply in such cases as well. As a result, a levy will be recognized as a liability only when the minimum threshold (the obligating event) has been reached.

The sixth and last issue addresses those entities that publish interim financial statements. The same principles that are applied in an entity's annual results must be applied to the interim results. This means that if the obligating event has not yet occurred as of the end of the reporting period, no liability may be recognized. The entity may also not recognize a liability for a levy in anticipation of the obligating event being reached by the end of the reporting period.



Any amounts that an entity may have prepaid in respect of a levy must be presented as an asset if the entity does not yet have a present obligation to pay the levy.

### Payee Unknown and the Amount May Have to Be Estimated

The following are further examples of estimated liabilities, which also will fall within the definition of provisions under IAS 37.

**Premiums** are usually offered by an entity to increase product sales. They may require the purchaser to return a specified number of box tops, wrappers or other proofs of purchase. They may or may not require the payment of a cash amount. If the premium offer terminates at the end of the current period but has not been accounted for completely if it extends into the next accounting period, a current liability for the estimated number of redemptions expected in the future period will have to be recorded. If the premium offer extends for more than one accounting period, the estimated liability must be divided into a current portion and a long-term portion.

**Product warranties** providing for repair or replacement of defective products may be sold separately or may be included in the sale price of the product. If the warranty extends into the next accounting period, a current liability for the estimated amount of warranty expense anticipated for the next period must be recorded. If the warranty spans more than the next period, the estimated liability must be partitioned into a current and long-term portion.

#### Example of product warranty expense accrual

The River Rocks Corporation manufactures clothes washers. It sells €900,000 of washing machines during its most recent month of operations. Based on its historical warranty claims experience, it provides for an estimated warranty expense of 2% of revenues with the following entry:

Warranty expense	18,000	
Provision for warranty claims		18,000

During the following month, River Rocks incurs €10,000 of actual labour and €4,500 of actual materials expenses to repair warranty claims, which it charges to the warranty claims provision with the following entry:

Provision for warranty claims	14,500	
Labour expense		10,000
Materials expense		4,500

River Rocks also sells three-year extended warranties on its washing machines that begin once the initial one-year manufacturer's warranty is completed. During one month, it sells €54,000 of extended warranties, which it records with the following entry:

Cash	54,000	
Unearned warranty revenue		54,000

This liability remains unaltered for one year from the purchase date, during the period of normal warranty coverage, after which the extended warranty servicing period begins. River Rocks recognizes the warranty revenue on a straight-line basis over the 36 months of the warranty period, using the following entry each month:

Unearned warranty revenue	1,500	
Warranty revenue		1,500

## Contingent Liabilities

IAS 37 defines a contingent liability as an obligation that is either

- A *possible* obligation arising from past events, the outcome of which will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events which are not wholly within the control of the reporting entity; *or*
- A *present* obligation arising from past events, which is not recognized either because it is not probable that an outflow of resources will be required to settle an obligation or the amount of the obligation cannot be measured with sufficient reliability.

Under IAS 37, the reporting entity does not recognize a contingent liability in its statement of financial position. Instead, it should disclose in the notes to the financial statements the following information:

1. An estimate of its financial effect;
2. An indication of the uncertainties relating to the amount or timing of any outflow; and
3. The possibility of any reimbursement.

Disclosure of this information is not required if the possibility of any outflow in settlement is remote, or if it is impracticable to do so.

Contingent liabilities may develop in a way not initially anticipated. Thus, it is imperative that they be reassessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If the outflow of future economic benefits becomes probable, then a provision is required to be recognized in the financial statements of the period in which the change in such a probability occurs (except in extremely rare cases, when no reliable estimate can be made of the amount needed to be recognized as a provision).

Contingent liabilities must be distinguished from estimated liabilities, although both involve uncertainties that will be resolved by future events. However, an estimate exists because of uncertainty about the amount of an event requiring an acknowledged accounting recognition. The event is known and the effect is known, but the amount itself is uncertain.

In a contingency, whether there will be an impairment of an asset or the occurrence of a liability is the uncertainty that will be resolved in the future. The amount is also usually uncertain, although that is not an essential characteristic defining the contingency.

### *Assessing the likelihood of contingent events*

It is tempting to express quantitatively the likelihood of the occurrence of contingent events (e.g., an 80% probability), but this exaggerates the degree of precision possible in the estimation process. For this reason, accounting standards have not been written to require quantification of the likelihood of contingent outcomes. Rather, qualitative descriptions, ranging along the continuum from remote to probable, have historically been prescribed.

IAS 37 sets the threshold for accrual at “more likely than not,” which most experts have defined as being a probability of very slightly over a 50% likelihood. Thus, if there is even a hint that the obligation is more likely to exist than to not exist, it will need to be formally recognized if an amount can be reasonably estimated for it. The impact will be both to make it much less ambiguous when a contingency should be recorded, and to force recognition of far more of these obligations at earlier dates than they are being given recognition at present.



When a loss is probable and no estimate is possible, these facts should be disclosed in the current period. The accrual of the loss should be made in the period in which the amount of the loss can be estimated. This accrual of a loss in future periods is a change in estimate. It is *not* to be presented as a prior period adjustment.

### ***Remote contingent losses***

With the exception of certain remote contingencies for which disclosures have traditionally been given, contingent losses that are deemed remote in terms of likelihood of occurrence are not accrued or disclosed in the financial statements. For example, every business risks loss by fire, explosion, government expropriation, or guarantees made in the ordinary course of business. These are all contingencies (though not necessarily contingent liabilities) because of the uncertainty surrounding whether the future event confirming the loss will or will not take place. The risk of asset expropriation exists, but this has become less common an occurrence in recent decades and, in any event, would be limited to less developed or politically unstable nations. Unless there is specific information about the expectation of such occurrences, which would thus raise the item to the possible category in any event, thereby making it subject to disclosure, these are not normally discussed in the financial statements.

### ***Litigation***

The most difficult area of contingencies accounting involves litigation. In some nations there is a great deal of commercial and other litigation, some of which exposes reporting entities to risks of incurring very material losses. Accountants must generally rely on attorneys' assessments concerning the likelihood of such events. Unless the attorney indicates that the risk of loss is remote or slight, or that the impact of any loss that does occur would be immaterial to the company, the accountant will require that the entity add explanatory material to the financial statements regarding the contingency. In cases where judgements have been entered against the entity, or where the attorney gives a range of expected losses or other amounts, certain accruals of loss contingencies for at least the minimum point of the range must be made. Similarly, if the reporting entity has made an offer in settlement of unresolved litigation, that offer would normally be deemed the lower end of the range of possible loss and, thus, subject for accrual. In most cases, however, an estimate of the contingency is unknown and the contingency is reflected only in footnotes.

#### **Example of illustrative footnotes—contingent liabilities**

1. A former plant manager of the establishment has filed a claim related to injuries sustained by him during an accident in the factory. The former employee is claiming approximately €3.5 million as damages for permanent disability, alleging that the establishment had violated a safety regulation. At the end of the reporting period, no provision has been made for this claim, as management intends to vigorously defend these allegations and believes the payment of any penalty is not probable.
2. Based on allegations made by a competitor, the company is currently the subject of a government investigation relating to antitrust matters. If the company is ultimately accused of violations of the country's antitrust laws, fines could be assessed. Penalties would include sharing of previously earned profits with a competitor on all contracts entered into from inception. The competitor has indicated to the governmental agency investigating the company that the company has made excessive profits ranging from €50 million to €75 million by resorting to restrictive trade practices

that are prohibited by the law of the country. No provision for any penalties or other damages has been made at the end of the reporting period since the company's legal counsel is confident that these allegations will not be sustained in a court of law.

### Financial Guarantee Contracts

Guarantees are commonly encountered in the commercial world; these can range from guarantees of bank loans made as accommodations to business associates to negotiated arrangements made to facilitate sales of the entity's goods or services. Guarantees had not been comprehensively addressed by IFRS prior to the mid-2005 amendment to IAS 39 and IFRS 4, which was made to explicitly deal with certain financial guarantee contracts.

IFRS provides guidance on the accounting for all financial guarantees—those which are in effect insurance, the accounting for which is therefore to be guided by the provisions of IFRS 4, and those which are not akin to insurance, and which are to be accounted for consistent with IAS 39. For purposes of applying this guidance, a financial guarantee contract is defined as a contract that requires 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. These are generally accounted for under the provisions of IAS 39, as follows:

- Financial guarantee contracts are initially recognized at fair value. For those financial guarantee contracts issued in stand-alone arm's-length transactions to unrelated parties, fair value at inception will be equal to the consideration received, unless there is evidence to the contrary.
- In subsequent periods, the guarantee is to be reported at the higher of (1) the amount determined in accordance with IAS 37, or (2) the amount initially recognized less, if appropriate, the cumulative amortization (to income) that was recognized in accordance with IAS 18.

If certain criteria are met, the issuer (guarantor) may elect to use the fair value option set forth in IAS 39. That is, the guarantee may be designated as simply being carried at fair value, with all changes being reported currently in profit or loss. (See Chapter 24 for discussion of the *fair value option*.)

The language of IAS 39 observes that financial guarantee contracts can have various legal forms (e.g., a guarantee, some types of letters of credit, a credit default contract, or an insurance contract), but that the proper accounting treatment does not depend on legal form.

The basic requirement is that financial guarantee contracts, as defined, are accounted for under IAS 39, not under IFRS 4. However, there is an important exception: if the guarantor/issuer had previously asserted explicitly that it regarded those as insurance contracts, and had accounted for them consistently with such a declaration, then it is permitted to make a onetime election (on a contract-by-contract basis) as to whether the contracts will be accounted for as insurance or as financial instruments. This is an irrevocable election.

### Contingent Assets

According to IAS 37, a contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events that are not wholly within the control of the reporting entity.

Contingent assets usually arise from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example of a contingent asset is a claim against an insurance company that the entity is pursuing legally.

Contingent assets should not be recognized; instead, they should be disclosed if the inflow of the economic benefits is probable. As with contingent liabilities, contingent assets need to be continually assessed to ensure that developments are properly reflected in the financial statements. For instance, if it becomes virtually certain that the inflow of economic benefits will arise, the asset and the related income should be recognized in the financial statements of the period in which the change occurs. If, however, the inflow of economic benefits has become probable (instead of virtually certain), then it should be disclosed as a contingent asset.

**Example of illustrative footnotes—gain contingency/contingent asset**

1. During the current year, a trial court found that a major multinational company had infringed on certain patents and trademarks owned by the company. The court awarded €100 million in damages for these alleged violations by the defendant. In accordance with the court order, the defendant will also be required to pay interest on the award amount and legal costs as well. Should the defendant appeal to an appellate court, the verdict of the trial court could be reduced or the amount of the damages could be reduced. Therefore, at the end of the reporting period, the company has not recognized the award amount in the accompanying financial statements since it is not virtually certain of the verdict of the appellate court.
2. In June 20XX, the company settled its longtime copyright infringement and trade secrets lawsuit with a competitor. Under the terms of the settlement, the competitor paid the company €2.5 million, which was received in full and final settlement in October 20XX, and the parties have dismissed all remaining litigation. For the year ended December 31, 20XX, the company recognized the amount received in settlement as “other income,” which is included in the accompanying financial statements.

**Disclosures Prescribed by IAS 37 for Contingent Liabilities and Contingent Assets**

An entity should disclose, for each class of contingent liability at the end of the reporting period, a brief description of the nature of the contingent liability and, where practicable, an estimate of its financial effect measured in the same manner as provisions, an indication of the uncertainties relating to the amount or timing of any outflow, and the possibility of any reimbursement.

In aggregating contingent liabilities to form a class, it is essential to consider whether the nature of the items is sufficiently similar to each other such that they could be presented as a single class.

In the case of contingent assets where an inflow of economic benefits is probable, an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period and, where practicable, an estimate of their financial effect, measured using the same principles as provisions.

Where any of the above information is not disclosed because it is not practical to do so, that fact should be disclosed. In extremely rare circumstances, if the above disclosures as envisaged by the standard are expected to seriously prejudice the position of the entity in a dispute with third parties on the subject matter of the contingencies, then the standard takes a lenient view and allows the entity to disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

**Disclosure Example****BP****December 31, 2014****(millions of US dollars)****Part of Note 1: Significant estimate or judgement: provisions**

The group holds provisions for the future decommissioning of oil and natural gas production facilities and pipelines at the end of their economic lives.

The largest decommissioning obligations facing BP relate to the plugging and abandonment of wells and the removal and disposal of oil and natural gas platforms and pipelines around the world. Most of these decommissioning events are many years in the future and the precise requirements that will have to be met when the removal event occurs are uncertain. Decommissioning technologies and costs are constantly changing, as well as political, environmental, safety and public expectations. BP believes that the impact of any reasonably foreseeable change to these provisions on the group's results of operations, financial position or liquidity will not be material. If oil and natural gas production facilities and pipelines are sold to third parties and the subsequent owner is unable to meet their decommissioning obligations, judgement must be used to determine whether BP is then responsible for decommissioning, and if so the extent of that responsibility. Consequently, the timing and amounts of future cash flows are subject to significant uncertainty. Any changes in the expected future costs are reflected in both the provision and the asset.

Decommissioning provisions associated with downstream and petrochemicals facilities are generally not recognized, as the potential obligations cannot be measured, given their indeterminate settlement dates. The group performs periodic reviews of its downstream and petrochemicals longlived assets for any changes in facts and circumstances that might require the recognition of a decommissioning provision.

The provision for environmental liabilities is estimated based on current legal and constructive requirements, technology, price levels and expected plans for remediation. Actual costs and cash outflows can differ from estimates because of changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions and changes in clean-up technology.

Other provisions and liabilities are recognized in the period when it becomes probable that there will be a future outflow of funds resulting from past operations or events and the amount of cash outflow can be reliably estimated. The timing of recognition and quantification of the liability require the application of judgement to existing facts and circumstances, which can be subject to change. Since the cash outflows can take place many years in the future, the carrying amounts of provisions and liabilities are reviewed regularly and adjusted to take account of changing facts and circumstances.

The timing and amount of future expenditures are reviewed annually, together with the interest rate used in discounting the cash flows. The interest rate used to determine the balance sheet obligation at the end of 2014 was a real rate of 0.75% (2013 1.0%), which was based on long-dated US government bonds.

Provisions and contingent liabilities relating to the Gulf of Mexico oil spill are discussed in Note 2. Information about the group's other provisions is provided in Note 21. As further described in Note 21, the group is subject to claims and actions. The facts and circumstances relating to particular cases are evaluated regularly in determining whether it is probable that there will be a future outflow of funds and, once established, whether a provision relating to a specific litigation should be established or revised. Accordingly, significant management judgement relating to provisions and contingent liabilities is required, since the outcome of litigation is difficult to predict.

Extract of Note 2 is not presented and can be referred to from their Annual Report available online.

## 21. Provisions

						\$ million
	Decommissioning	Environmental <sup>a</sup>	Litigation and claims	Clean Water Act penalties	Other	Total
At 1 January 2014	<b>17,205</b>	<b>3,454</b>	<b>4,911</b>	<b>3,510</b>	<b>2,880</b>	<b>31,960</b>
Exchange adjustments	<b>(489)</b>	<b>(18)</b>	<b>(12)</b>	–	<b>(122)</b>	<b>(641)</b>
Acquisitions	<b>8</b>	–	–	–	<b>13</b>	<b>21</b>
New or increased provisions	<b>2,216</b>	<b>561</b>	<b>1,290</b>	–	<b>1,101</b>	<b>5,168</b>
Write-back of unused provisions	<b>(60)</b>	<b>(92)</b>	<b>(27)</b>	–	<b>(252)</b>	<b>(431)</b>
Unwinding of discount	<b>202</b>	<b>19</b>	<b>12</b>	–	<b>24</b>	<b>257</b>
Change in discount rate	<b>778</b>	<b>21</b>	<b>14</b>	–	<b>9</b>	<b>822</b>
Utilization	<b>(682)</b>	<b>(1,098)</b>	<b>(1,449)</b>	–	<b>(565)</b>	<b>(3,794)</b>
Deletions	<b>(458)</b>	–	–	–	<b>(6)</b>	<b>(464)</b>
At 31 December 2014	<b>18,720</b>	<b>2,847</b>	<b>4,739</b>	<b>3,510</b>	<b>3,082</b>	<b>32,898</b>
Of which – current	<b>836</b>	<b>927</b>	<b>1,420</b>	–	<b>635</b>	<b>3,818</b>
– non-current	<b>17,884</b>	<b>1,920</b>	<b>3,319</b>	<b>3,510</b>	<b>2,447</b>	<b>29,080</b>
Of which – Gulf of Mexico oil spill <sup>b</sup>	–	<b>1,141</b>	<b>3,954</b>	<b>3,510</b>	–	<b>8,605</b>

<sup>a</sup> Spill response provisions are now included within environmental provisions as they are no longer individually significant.

<sup>b</sup> Further information on the financial impacts of the Gulf of Mexico oil spill is provided in Note 2.

The decommissioning provision comprises the future cost of decommissioning oil and natural gas wells, facilities and related pipelines. The environmental provision includes provisions for costs related to the control, abatement, clean-up or elimination of environmental pollution relating to soil, groundwater, surface water and sediment contamination. The litigation and claims category includes provisions for matters related to, for example, commercial disputes, product liability, and allegations of exposures of third parties to toxic substances. Included within the other category at 31 December 2014 are provisions for deferred employee compensation of \$553 million (2013 \$602 million).

For information on significant estimates and judgements made in relation to provisions, including those for the Gulf of Mexico oil spill, see Provisions, contingencies and reimbursement assets within Note 1.

## REPORTING EVENTS OCCURRING AFTER THE REPORTING PERIOD

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The issue addressed by IAS 10 is to what extent anything that happens between the entity's end of the reporting period and the date the financial statements are authorized for issue should be reflected in those financial statements. The standard distinguishes between events that provide information about the state of the entity existing at the end of the reporting period, and those that concern the next financial period. A secondary issue is the cutoff point beyond which the financial statements are considered to be finalized.

### *Authorization date*

The determination of the authorization date (i.e., the date when the financial statements could be considered legally authorized for issuance, generally by action of the board of directors of the reporting entity) is critical to the concept of events after the reporting period. It serves as the cutoff point after the reporting period, up to which the events after the reporting period are to be examined in order to ascertain whether such events qualify for the treatment prescribed by IAS 10. This standard explains the concept through the use of illustrations.

The general principles that need to be considered in determining the authorization date of the financial statements are set out below.

- When an entity is required to submit its financial statements to its shareholders for approval after they have already been issued, the authorization date in this case would mean the date of original issuance and not the date when these are approved by the shareholders; and
- When an entity is required to issue its financial statements to a supervisory board made up wholly of non-executives, authorization date would mean the date on which management authorizes them for issue to the supervisory board.

Consider the following examples:

1. The preparation of the financial statements of Xanadu Corp. for the reporting period ended December 31, 20XX, was completed by the management on February 15, 20XX+1. The draft financial statements were considered at the meeting of the board of directors held on February 18, 20XX+1, on which date the Board approved them and authorized them for issuance. The annual general meeting (AGM) was held on March 28, 20XX+1, after allowing for printing and the requisite notice period mandated by the corporate statute. At the AGM the shareholders approved the financial statements. The approved financial statements were filed by the corporation with the Company Law Board (the statutory body of the country that regulates corporations) on April 6, 20XX+1.

Given these facts, the date of authorization of the financial statements of Xanadu Corp. for the year ended December 31, 20XX, is February 18, 20XX+1, the date when the board approved them and authorized them for issue (and not the date they were approved in the AGM by the shareholders). Thus, all post-reporting period events between December 31, 20XX, and February 18, 20XX+1, need to be considered by Xanadu Corp. for the purposes of evaluating whether or not they are to be accounted or reported under IAS 10.

2. Suppose in the above cited case the management of Xanadu Corp. was required to issue the financial statements to a supervisory board (consisting solely of non-executives including representatives of a trade union). The management of Xanadu Corp. had issued the draft financial statements to the supervisory board on February 16, 20XX+1.



The supervisory board approved them on February 17, 20XX+1 and the shareholders approved them in the AGM held on March 28, 20XX+1. The approved financial statements were filed with the Company Law Board on April 6, 20XX+1.

In this case the date of authorization of financial statements would be February 16, 20XX+1, the date the draft financial statements were issued to the supervisory board. Thus, all post-reporting period events between December 31, 20XX, and February 16, 20XX+1, need to be considered by Xanadu Corp. for the purposes of evaluating whether or not they are to be accounted or reported under IAS 10.

***Adjusting and non-adjusting events (after the reporting period)***

Two types of events after the reporting period are distinguished by the standard. These are, respectively, “adjusting events after the reporting period” and “non-adjusting events after the reporting period.” Adjusting events are those post-reporting period events that provide evidence of conditions that actually existed at the end of the reporting period, albeit they were not known at the time. Financial statements should be adjusted to reflect adjusting events after the reporting period.

Examples of *adjusting events*, given by the standard, are the following:

1. Resolution after the reporting period of a court case that confirms a present obligation requiring either an adjustment to an existing provision or recognition of a provision instead of mere disclosure of a contingent liability;
2. Receipt of information after the reporting period indicating that an asset was impaired or that a previous impairment loss needs to be adjusted. For instance, the bankruptcy of a customer subsequent to the end of the reporting period usually confirms the existence of loss at the end of the reporting period, and the disposal of inventories after the reporting period provides evidence (not always conclusive, however) about their net realizable value at the date of the statement of financial position;
3. The determination after the reporting period of the cost of assets purchased, or the proceeds from assets disposed of, before the reporting date;
4. The determination subsequent to the end of the reporting period of the amount of profit sharing or bonus payments, where there was a present legal or constructive obligation at the reporting date to make the payments as a result of events before that date; and
5. The discovery of frauds or errors, after the reporting period, that show that the financial statements were incorrect at the reporting date before the adjustment.

Commonly encountered situations of adjusting events are illustrated below.

- During the year 20XX Taj Corp. was sued by a competitor for €10 million for infringement of a trademark. Based on the advice of the company’s legal counsel, Taj accrued the sum of €5 million as a provision in its financial statements for the year ended December 31, 20XX. Subsequent to the date of the statement of financial position, on February 15, 20XX+1, the Supreme Court decided in favour of the party alleging infringement of the trademark and ordered the defendant to pay the aggrieved party a sum of €7 million. The financial statements were prepared by the company’s management on January 31, 20XX+1, and approved by the Board on February 20, 20XX+1. Taj Corp. should adjust the provision by €2 million to reflect the award decreed by the Supreme Court (assumed to be the final appellate authority on the matter in this example) to be paid by Taj Corp. to its competitor. Had the judgement of the Supreme Court been delivered on February 25, 20XX+1, or later,

this post-reporting period event would have occurred after the cutoff point (i.e., the date the financial statements were authorized for original issuance). If so, adjustment of financial statements would not have been required.

- Penn Corp. carries its inventory at the lower of cost and net realizable value. At December 31, 20XX, the cost of inventory, determined under the first-in, first-out (FIFO) method, as reported in its financial statements for the year then ended, was €5 million. Due to severe recession and other negative economic trends in the market, the inventory could not be sold during the entire month of January 20XX+1. On February 10, 20XX+1, Penn Corp. entered into an agreement to sell the entire inventory to a competitor for €4 million. Presuming the financial statements were authorized for issuance on February 15, 20XX+1, the company should recognize a write-down of €1 million in the financial statements for the year ended December 31, 20XX, provided that this was determined to be an indicator of the value at year-end.

In contrast with the foregoing, *non-adjusting events* are those post-reporting period events that are indicative of conditions that arose after the reporting period. Financial statements should not be adjusted to reflect non-adjusting events after the end of the reporting period. An example of a non-adjusting event is a decline in the market value of investments between the date of the statement of financial position and the date when the financial statements are authorized for issue. Since the fall in the market value of investments after the reporting period is not indicative of their market value at the date of the statement of financial position (instead it reflects circumstances that arose subsequent to the end of the reporting period) the fall in market value need not, and should not, be recognized in the financial statements at the date of the statement of financial position.

Not all non-adjusting events are significant enough to require disclosure, however. The revised standard gives examples of non-adjusting events that would impair the ability of the users of financial statements to make proper evaluations or decisions if not disclosed. Where non-adjusting events after the reporting period are of such significance, disclosure should be made for each such significant category of non-adjusting event, of the nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made. Examples given by the standard of such significant non-adjusting post-reporting period events are the following:

1. A major business combination or disposing of a major subsidiary;
2. Announcing a plan to discontinue an operation;
3. Major purchases and disposals of assets or expropriation of major assets by government;
4. The destruction of a major production plant by fire;
5. Announcing or commencing the implementation of a major restructuring;
6. Abnormally large changes in asset prices or foreign exchange rates;
7. Significant changes in tax rates and enacted tax laws;
8. Entering into significant commitments or contingent liabilities; and
9. Major litigation arising from events occurring after the reporting period.

#### ***Dividends proposed or declared after the reporting period***

Dividends on equity instruments proposed or declared after the reporting period should not be recognized as a liability at the end of the reporting period. Such declaration is a non-adjusting subsequent event, in other words. While at one time IFRS did permit accrual of post-balance sheet dividend declarations, this has not been permissible for quite some time.



Furthermore, the revisions made to IAS 10 as part of the IASB's Improvements Project in late 2003 (which became effective 2005) also eliminated the display of post-reporting period dividends as a separate component of equity, as was formerly permitted. Footnote disclosure is, on the other hand, required unless immaterial.

A further clarification has been added by the 2008 *Improvements*, a collection of major and minor changes made in 2008. It states that, if dividends are declared (i.e., the dividends are appropriately authorized and no longer at the discretion of the entity) after the reporting period but before the financial statements are authorized for issue, the dividends are not recognized as a liability at the end of the reporting period, for the very simple reason that *no obligation exists at that time*. This rudimentary expansion of the language of IAS 10 was deemed necessary because it had been asserted that a *constructive obligation* could exist under certain circumstances, making formal accrual of a dividend liability warranted. The *Improvements* language makes it clear that this is never the case.

### ***Going concern considerations***

Deterioration in an entity's financial position after the end of the reporting period could cast substantial doubts about an entity's ability to continue as a going concern. IAS 10 requires that an entity should not prepare its financial statements on a going concern basis if management determines after the end of the reporting period either that it intends to liquidate the entity or cease trading, or that it has no realistic alternative but to do so. IAS 10 notes that disclosures prescribed by IAS 1 under such circumstances should also be complied with.

### ***Disclosure requirements***

The following disclosures are mandated by IAS 10:

1. The date when the financial statements were authorized for issue and who gave that authorization. If the entity's owners have the power to amend the financial statements after issuance, this fact should be disclosed;
2. If information is received after the reporting period about conditions that existed at the date of the statement of financial position, disclosures that relate to those conditions should be updated in the light of the new information; and
3. Where non-adjusting events after the reporting period are of such significance that non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions, disclosure should be made for each such significant category of non-adjusting event, of the nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made.

## **EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES**

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### **Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX**

#### **35.1 Flood damage**

A widget manufacturing factory was severely damaged in a flash flood on the 17 January 20XX. The value of the factory and its contents were insured in full and claims put forward to the insurers are being processed. The group was

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however not insured for the loss of business due to factory down time. The loss of business is estimated to result in financial losses of £ X.

### 35.2 Acquisition of a subsidiary

After the reporting period but before the financial statements were authorized for issue the group acquired 100% of the share capital of Subsidiary D Ltd. The fair value of assets acquired and liabilities assumed on the acquisition date of 1 February 20XX were as follows:

IFRS3 Pb64

	£
Cash	X
Inventories	X
Trade receivables	X
Property, plant and equipment	X
Trade payables	X
Long-term debt	X
Total net assets	X
Goodwill	X
Total fair value of consideration paid	X
Less: Fair value of shares issued	X
Cash	X
Less: Cash of Subsidiary D Ltd	X
Cash flow on acquisition net of cash acquired	X

Goodwill represents the value of the synergies arising from the vertical integration of the group's operations. These synergistic benefits were the primary reason for entering into the business combination. The total amount of goodwill that is expected to be deductible for tax purposes is £X.

## FUTURE DEVELOPMENTS

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In June 2005 the IASB issued an Exposure Draft (ED), *Proposed Amendments to IAS 37: Provisions, Contingent Liabilities and Contingent Assets*. On January 5, 2010, the IASB published a second ED, *Measurement of Liabilities in IAS 37*, that contains revised proposals for measuring liabilities within the scope of IAS 37. This project was a major project but has since been changed to a research project. This project has since not been added to the active agenda of the IASB and no new documents have been issued.

As a major project IFRS 15 has been issued and this becomes applicable to entities from a later date. However, once this standard is applied, it will have impact on IAS 37 and the key implication is detailed hereunder:

- Type of provision, contingent liability and contingent asset arising from IFRS 15, *Revenue from Contracts with Customers* shall be dealt with as detailed therein and not under IAS 37.
- However, as IFRS 15 does not deal specifically with contracts with customers that are, or have become, onerous, the same will continue to be dealt with under IAS 37.

## US GAAP COMPARISON

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There are substantial differences between US GAAP and IFRS with regard to provisions. US GAAP does not use the term "provisions." The term "accrual" is used instead.

Under US GAAP, constructive obligations are only recognized for environmental obligations, decommissioning obligations, post-retirement benefits and legal disputes. Discount rates used to measure provisions at present value are a risk-adjusted risk-free rate that reflects the entity's credit standing.

To recognize a contingency under GAAP, a loss must be "probable." Although a percentage is not assigned, it generally means a high likelihood. Under IFRS, "probable" is interpreted as more likely than not, which refers to a probability of greater than 50%.

When a range of estimates is available for a provision, the minimum amount is accrued under US GAAP when other estimates are equally probable, including zero. IFRS uses the single most likely estimate to measure a provision.

Under US GAAP, joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date are recognized as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. However, this measurement attribute does not apply if the obligations are addressed within existing US GAAP.

Onerous contracts are not recognized as provisions. The effects are recognized upon settlement of the obligation. Exit costs are provided for only when a detailed plan is in place and recipients of severance have agreed to the terms. Costs for which employees are required to work are recognized as the work is performed.

Asset retirement obligations (AROs) are largely the same, but the difference in the discount rate used to measure the obligations creates an inherent difference in the carrying value. To discount the obligation, US GAAP uses a risk-free rate adjusted for the entity's credit risk. IFRS uses the time value of money rate adjusted for specific risks of the liability. Also, period-to-period changes in the discount rate do not affect an accrual that has not changed. The discount rate applied to each increment of an accrual, termed "layers" in US GAAP, remains within that layer. Also, AROs are not recognized under GAAP unless there is a present legal obligation and the fair value of the obligation can be reasonably estimated.

Under US GAAP, provisions may be discounted when the liability's amount and timing are fixed or reliably determinable or when the obligation is at fair value. The discount rate depends on the nature of the accrual.

Regarding restructuring costs, under US GAAP, once management has committed to a restructuring plan, each type of cost is examined to determine when it should be recognized. Involuntary employee terminations costs under a one-time benefit arrangement are expensed over the future service period. If no future service is required, the costs are expensed immediately. Other exit costs are expensed when incurred.

employee compensation, share-based compensation arrangements, is dealt with in terms of IFRS 2, which is addressed in detail in Chapter 17 of this publication.

Pension plans traditionally have existed in two basic varieties: defined contribution and defined benefit. The accounting for the latter is comparatively more complex. Defined benefit plan accounting in particular remains a controversial subject because of the heavy impact that various management assumptions have on expense determination.

IAS 19 also establishes requirements for disclosures to be made by employers when defined contribution or defined benefit pension plans are settled, curtailed or terminated.

IAS 19 defines all post-employment benefits other than defined contribution plans as defined benefit plans and, thus, all the accounting complexities of defined benefit pension plans would apply. These difficulties may be exacerbated, in the case of post-retirement health care plans, by the need to project the future escalation in health care costs over a rather lengthy time horizon, which is a famously difficult exercise to undertake.

In July 2007, IFRIC 14 was issued, addressing the problems that arise from the interaction between the limitation on defined benefit plan asset recognition by employers/plan sponsors under IAS 19 and the statutory minimum funding requirements that exist under some jurisdictions. An amendment to IFRIC 14 was issued in November 2009 to correct an unintended consequence of that interpretation, which caused certain reporting entities, under some circumstances, to be prevented from recognizing as an asset some prepayments for minimum funding contributions.

<i>IAS 19</i>	<b>Sources of IFRS</b> <i>IFRIC 14</i>
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## DEFINITIONS OF TERMS

**Accrued benefit obligation.** Actuarial present value of benefits (whether vested or non-vested) attributed by the pension benefit formula to employee service rendered before a specified date and based on employee service and compensation (if applicable) prior to that date.

**Accrued benefit valuation methods.** Actuarial valuation methods that reflect retirement benefits based on service rendered by employees to the date of the valuation. Assumptions about projected salary levels to the date of retirement must be incorporated, but service to be rendered after the end of the reporting period is not considered in the calculation of pension cost or of the related obligation.

**Accrued pension cost.** Cumulative net pension cost accrued in excess of the employer's contributions.

**Accrued post-retirement benefit obligation.** The actuarial present value of benefits attributed to employee service rendered as of a particular date. Prior to an employee's full eligibility date, the accrued post-retirement benefit obligation as of a particular date for an employee is the portion of the expected post-retirement benefit obligation attributed to that employee's service rendered to that date. On and after the full eligibility date, the accrued and expected post-retirement benefit obligations for an employee are the same.

**Actuarial gains and losses.** Include (1) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), and (2) the effects of changes in actuarial assumptions.

**Actuarial present value.** Value, as of a specified date, of an amount or series of amounts payable or receivable thereafter, with each amount adjusted to reflect (1) the time value of

money (through discounts for interest), and (2) the probability of payment (by means of decrements for events such as death, disability, withdrawal, or retirement) between the date specified and the expected date of payment.

**Actuarial valuation.** The process used by actuaries to estimate the present value of benefits to be paid under a retirement plan and the present values of plan assets and sometimes also of future contributions.

**Asset ceiling.** The present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

**Attribution.** Process of assigning pension benefits or cost to periods of employee service.

**Career-average-pay formula (career-average-pay plan).** Benefit formula that bases benefits on the employee's compensation over the entire period of service with the employer. A career-average-pay plan is a plan with such a formula.

**Contributory plan.** Pension plan under which employees contribute part of the cost. In some contributory plans, employees wishing to be covered must contribute; in other contributory plans, employee contributions result in increased benefits.

**Defined benefit pension plan.** Any post-employment benefit plan other than a defined contribution plan. These are generally retirement benefit plans under which amounts to be paid as retirement benefits are determinable, usually by reference to employees' earnings and/or years of service. The fund (and/or employer) is obligated either legally or constructively to pay the full amount of promised benefits whether or not sufficient assets are held in the fund.

**Defined contribution pension plan.** Benefit plans under which amounts to be paid as retirement benefits are determined by the contributions to a fund together with accumulated investment earnings thereon; the plan has no obligation to pay further sums if the amounts available cannot pay all benefits relating to employee services in the current and prior periods.

**Employee benefits.** All forms of consideration to employees in exchange for services rendered.

**Expected long-term rate of return on plan assets.** Assumption as to the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested, or to be invested, to provide for the benefits included in the projected benefit obligation.

**Expected post-retirement benefit obligation.** The actuarial present value as of a particular date of the benefits expected to be paid to or for an employee, the employee's beneficiaries, and any covered dependents pursuant to the terms of the post-retirement benefit plan.

**Expected return on plan assets.** The expected return on plan assets is determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets.

**Experience adjustments.** Adjustments to benefit costs arising from the differences between the previous actuarial assumptions as to future events and what actually occurred.

**Fair value.** Amount that an asset could be exchanged for between willing, knowledgeable parties in an arm's-length transaction.

**Final-pay plan.** A defined benefit plan that promises benefits based on the employee's remuneration at or near the date of retirement. It may be the compensation of the final year, or of a specified number of years near the end of the employee's service period.

**Fund.** Used as a verb, to pay over to a funding agency (as to fund future pension benefits or to fund pension cost). Used as a noun, assets accumulated in the hands of a funding agency for the purpose of meeting pension benefits when they become due.

**Funding.** The irrevocable transfer of assets to an entity separate from the employer's entity, to meet future obligations for the payment of retirement benefits.

**Measurement date.** Date as of which plan assets and obligations are measured.

**Mortality rate.** Proportion of the number of deaths in a specified group to the number living at the beginning of the period in which the deaths occur. Actuaries use mortality tables,

which show death rates for each age, in estimating the amount of pension benefits that will become payable.

**Multiemployer plans.** Defined contribution plans or defined benefit plans, other than state plans, that (1) pool the assets contributed by various entities that are not under common control; and (2) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

**Net interest on the net defined benefit liability (asset).** The change during the period in the net defined benefit liability (asset) that arises from the passage of time.

**Other long-term employee benefits.** Benefits other than post-employment, termination and stock equity compensation benefits, that are not due to be settled within 12 months after the end of the period in which service was rendered.

**Past service cost.** The change in the present value of the defined benefit obligation for employee services in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when existing benefits are changed so that the present value of the defined benefit obligation decreases).

**Pay-as-you-go.** A method of recognizing the cost of retirement benefits only at the time that cash payments are made to employees on or after retirement.

**Plan amendment.** Change in terms of an existing plan or the initiation of a new plan. A plan amendment may increase benefits, including those attributed to years of service already rendered.

**Plan assets.** The assets held by a long-term employee benefit fund, and qualifying insurance policies. Regarding assets held by a long-term employee benefit fund, these are assets (other than non-transferable financial instruments issued by the reporting entity) that both:

1. Are held by a fund that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
2. Are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in the event of bankruptcy), and cannot be returned to the reporting entity unless either:
  - a. The remaining assets of the fund are sufficient to meet all related employee benefit obligations of the plan or the entity; or
  - b. The assets are returned to the reporting entity to reimburse it for employee benefits already paid by it.

Regarding the qualifying insurance policy, this must be issued by a non-related party if the proceeds of the policy both:

1. Can be used only to pay or fund employee benefits under a defined benefit plan; and
2. Are not available to the reporting entity's own creditors (even in the event of bankruptcy) and cannot be returned to the reporting entity unless either:
  - a. The proceeds represent surplus assets that are not needed for the policy to meet all related employee benefit obligations; or
  - b. The proceeds are returned to the reporting entity to reimburse it for employee benefits already paid by it.



**Post-employment benefit plans.** Formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

**Post-employment benefits.** Employee benefits, other than termination benefits, which are payable after the completion of employment.

**Post-retirement benefits.** All forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits, such as health care, tuition assistance or legal services, that are provided to retirees as the need for those benefits arises, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits.

**Prepaid pension cost.** Cumulative employer contributions in excess of accrued net pension cost.

**Present value of a defined benefit obligation.** Present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

**Prior service cost.** Cost of retroactive benefits granted in a plan amendment.

**Projected benefit obligation.** The actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using assumptions as to future compensation levels if the pension benefit formula is based on those future compensation levels (pay-related, final-pay, final-average-pay or career-average-pay plans).

**Projected benefit valuation methods.** Actuarial valuation methods that reflect retirement benefits based on service both rendered and to be rendered by employees, as of the date of the valuation. Contrasted with accumulated benefit valuation methods, projected benefit valuation methods will result in a more level assignment of costs to the periods of employee service, although this will not necessarily be a straight-line allocation. Assumptions about projected salary levels must be incorporated. This was the allowed alternative method under the prior version of IAS 19, but is prohibited under the current standard.

**Retirement benefit plans.** Formal or informal arrangements whereby employers provide benefits for employees on or after termination of service, when such benefits can be determined or estimated in advance of retirement from the provisions of a document or from the employers' practices.

**Retroactive benefits.** Benefits granted in a plan amendment (or initiation) that are attributed by the pension benefit formula to employee services rendered in periods prior to the amendment. The cost of the retroactive benefits is referred to as prior service cost.

**Return on plan assets.** Interest, dividends and other revenues derived from plan assets, together with realized and unrealized gains or losses on the plan assets, less administrative costs (other than those included in the actuarial assumptions used to measure the defined benefit obligation) including taxes payable by the plan.

**Service.** Employment taken into consideration under a pension plan. Years of employment before the inception of a plan constitute an employee's past service; years thereafter are classified in relation to the particular actuarial valuation being made or discussed. Years of employment (including past service) prior to the date of a particular valuation constitute prior service.

**Service costs.** Comprised of:

***Current service cost***

1. The increase in the present value of the defined benefit obligation resulting from services rendered by employees during the period.

**Past service cost**

2. The change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a **curtailment** (a significant reduction by the entity in the number of employees covered by a plan), and
3. Any gain or loss on **settlement**.

**Settlement.** A transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

**Short-term employee benefits.** Benefits other than termination and equity compensation benefits that are due to be settled within 12 months after the end of the period in which the employees rendered the related service.

**Terminal funding.** A method of recognizing the projected cost of retirement benefits only at the time an employee retires.

**Termination benefits.** Employee benefits payable as a result of the entity's termination of employment before normal retirement or the employee's acceptance of early retirement inducements.

**Vested benefits.** Those benefits which under the terms of a retirement benefit plan are not conditional on continued employment.

## BACKGROUND

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### Importance of Pension and Other Benefit Plan Accounting

For a variety of cultural, economic and political reasons, the existence of private pension plans has increased tremendously over the past 40 years, and these arrangements are the most common and desired of the assorted "fringe benefits" offered by employers in many nations. Under the laws of some nations, employers may be required to have such programs in place for their permanent employees. For many entities, pension costs have become a very material component of the total compensation paid to employees. Unlike for wages and other fringe benefits, the timing of the payment of cash to either the plan's administrators or to the plan beneficiaries can vary substantially from the underlying economic event (that is, the plans are not always fully funded on a current basis). This creates the possibility of misleading financial statement representation of the true costs of conducting business, unless a valid accrual method is employed. For this reason, and also because of the complexity of these arrangements and the impact they have on the welfare of the workers, accounting for the cost of pension plans and similar schemes (post-retirement benefits other than pensions, etc.) has received a great deal of attention from national and international standards setters.

### Basic Objectives of Accounting for Pension and Other Benefit Plan Costs

#### *Need for pension accounting rules*

The principal objectives of pension accounting are to measure the compensation cost associated with employees' benefits and to recognize that cost over the employees' respective



service periods. The relevant standard, IAS 19, is concerned only with the accounting aspects of pensions (and other benefit plans). The funding of pension benefits is considered to be financial management and legal concerns, and accordingly, is not addressed by this pronouncement.

When an entity provides benefits, the amounts of which can be estimated in advance, to its retired employees and their beneficiaries, the arrangement is deemed to be a pension plan. The typical plan is written, and the amounts of future benefits can be determined by reference to the plan documents. However, the plan and its provisions can also be implied from unwritten but established past practices. Plans may be unfunded, insured, trust fund, defined contribution and defined benefit plans, and deferred compensation contracts, if equivalent. Independent (i.e., not employer-sponsored) deferred profit-sharing plans and pension payments which are made to selected employees on a case-by-case basis are not considered pension plans.

The establishment of a pension plan represents a long-term financial commitment to employees. Although some entities manage their own plans, this commitment usually takes the form of contributions that are made to an independent trustee or, in some countries, to a governmental agency. These contributions are used by the trustee to acquire plan assets of various kinds, although the available types of investments may be restricted by governmental regulations in certain jurisdictions. Plan assets are used to generate a financial return, which typically consists of earned interest and/or appreciation in asset values.

The earnings from the plan assets (and occasionally, the proceeds from their liquidation) provide the trustee with cash to pay the benefits to which the employees become entitled at the date of their retirements. These benefits in turn are defined by the terms of the pension plan, which is known as the plan's benefit formula. In the case of defined benefit plans, the benefit formula incorporates many factors, including the employee's current and future compensation, service longevity, age and so on. The benefit formula is the best indicator of the plan's obligations at any point in time. It is used as the basis for determining the pension cost to be recognized each fiscal year.

## **BASIC PRINCIPLES OF IAS 19**

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### ***Applicability: Pension plans***

IAS 19 is applicable to both defined contribution and defined benefit pension plans. The accounting for *defined contribution* plans is normally straightforward, with the objective of matching the cost of the program with the periods in which the employees earn their benefits. Since contributions are formula-driven (e.g., as a percentage of wages paid), typically the payments to the plan will be made currently; if they do not occur by the end of the reporting period, an accrual will be recognized for any unpaid current contribution liability. Once made or accrued, the employer has no further obligation for the value of the assets held by the plan or for the sufficiency of fund assets for payment of the benefits, absent any violation of the terms of the agreement by the employer. Employees thus suffer or benefit from the performance of the assets in which the contributions made on their behalf were invested; often the employees themselves are charged with responsibility for selecting those investments.

IAS 19 requires that disclosure be made of the amount of expense recognized in connection with a defined contribution pension plan. If not explicitly identified in the statement of profit or loss and other comprehensive income, this should therefore be disclosed in the notes to the financial statements.

Compared to defined contribution plans, the accounting for *defined benefit* plans is vastly more complex, because the employer (sponsor) is responsible not merely for the current contribution to be made to the plan on behalf of participants, but additionally for the sufficiency of the assets in the plan for the ultimate payments of benefits promised to the participants. Thus the current contribution is at best a partial satisfaction of its obligation, and the amount of actual cost incurred is not measured by this alone. The measurement of pension cost under a defined benefit plan necessarily involves the expertise of actuaries—persons who are qualified to estimate the numbers of employees who will survive (both as employees, in the case of vesting requirements which some of them may not yet have met; and as living persons who will be present to receive the promised retirement benefits), the salary levels at which they will retire (if these are incorporated into the benefit formula, as is commonly the case), their expected life expectancy (since benefits are typically payable for life), and other factors which will influence the amount of resources needed to satisfy the employer's promises. Accounting for defined benefit plans is described at length in the following pages.

***Applicability: Other employee benefit plans***

IAS 19 explicitly applies to not merely pension plans, but also three other categories of employee and post-employment benefits. These are:

1. *Short-term employee benefits*, which include normal wages and salaries as well as compensated absences, profit sharing and bonuses, and such non-monetary fringe benefits as health insurance, housing subsidies and employer-provided automobiles, to the extent these are granted to current (not retired) employees.
2. *Other long-term employee benefits*, such as long-term (sabbatical) leave, long-term disability benefits and, if payable after 12 months beyond the end of the reporting period, profit sharing and bonus arrangements and deferred compensation.
3. *Termination benefits*, which are payments to be made upon termination of employment under defined circumstances, generally when employees are induced to leave employment before normal retirement age.

Each of the foregoing categories of employee benefits will be explained later in this chapter.

IAS 19 also addresses post-employment benefits *other than pensions*, such as retiree medical plan coverage, as part of its requirements for pension plans, since these are essentially similar in nature. These are also discussed further later in this chapter.

IAS 19 considers all plans other than those explicitly structured as defined contribution plans to be defined benefit plans. Unless the employer's obligation is strictly limited to the amount of contribution currently due, typically driven by a formula based on entity performance or by employee wages or salaries, the obligations to the employees (and the amount of recognizable expense) will have to be estimated in accordance with actuarial principles.

***Cost recognition distinguished from funding practices***

Although it is arguably a sound management practice to fund retirement benefit plans on a current basis, in some jurisdictions the requirement to do this is either limited or absent entirely. Furthermore, in some jurisdictions the currently available tax deduction for contributions to pension plans may be limited, reducing the incentive to make such contributions until such time as the funds are actually needed for making payouts to retirees.

Since the objective of periodic financial reporting is to match costs and revenues properly on a current basis, the pattern of funding is obviously not always going to be a useful guide to proper accounting for pension costs.

## **POST-EMPLOYMENT BENEFIT PLANS**

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### *General discussion*

Absent specific information to the contrary, it is assumed that a company will continue to provide retirement benefits well into the future. The accounting for the plan's costs should be reflected in the financial statements and these amounts should not be discretionary. All pension costs—with the exception noted below—should be charged against income. No amounts should be charged directly to retained earnings. The principal focus of IAS 19 is on the allocation of cost to the periods being benefited, which are the periods in which the covered employees provide service to the reporting entity.

### *Periodic measurement of cost for defined contribution plans*

Under the terms of a defined contribution plan, the employer will be obligated for fixed or determinable contributions in each period, often computed as a percentage of the wage and salary base paid to the covered employees during the period. For one example, contributions might be set at 4% of each employee's wages and salaries, up to €50,000 wages per annum. Generally, the contributions must actually be made by a specific date, such as 90 days after the end of the reporting entity's fiscal year, consistent with local law. The expense must be accrued for accounting purposes in the year the cost is incurred, whether the contribution is made currently or not.

IAS 19 requires that contributions payable to a defined contribution plan be accrued currently, even if not paid by year-end. If the amount is due over a period extending more than one year from the end of the reporting period, the long-term portion should be discounted at the rate applicable to high quality long-term corporate bonds. For currencies, where deep market for such high quality corporate bonds is not available, market yields applicable to government bonds denominated in such currencies is the alternative.

Past service costs arise when a plan is amended retroactively, so that additional attribution for benefits is given to services rendered in past years. The expense related to past service cost is recognized in income when the related plan amendment, curtailment or settlement occurs.

### *Periodic measurement of cost for defined benefit plans*

Defined benefit plans present a far greater challenge to accountants than do defined contribution plans, since the amount of expense to be recognized currently will need to be determined on an actuarial basis. Under current IFRS, only the accrued benefit valuation method may be used to measure defined benefit plan pension cost. Furthermore, only a single variant of the accrued benefit method—the “projected unit credit” method—is permitted.

Net periodic pension cost will consist of the sum of the following components:

1. Service costs:
  - a. Current service costs.
  - b. Past service costs.
  - c. Gain or loss on settlement.

2. Net interest cost for the current period on the net defined benefit liability (asset).
3. Remeasurement of the net defined benefit liability (asset):
  - a. Actuarial gains and losses.

Return on plan assets, excluding amounts included in net interest on:

- b. The net defined benefit liability (asset); and
- c. Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Disclosures required by IAS 19 effectively require that these cost components be displayed in the notes to the financial statements.

### ***Current service cost***

Current service cost must be determined by an actuarial valuation and will be affected by assumptions such as expected turnover of staff, average retirement age, the plan's vesting schedule, and life expectancy after retirement. The probable progression of wages over the employees' remaining working lives will also have to be taken into consideration if retirement benefits will be affected by levels of compensation in later years, as will be true in the case of career-average and final pay plans, among others.

It is worth stressing this last point: when pension arrangements call for benefits to be based on the employees' ultimate salary levels, experience will show that those benefits will increase, and any computation based on current salary levels will surely understate the actual economic commitment to the future retirees. Accordingly, IFRS requires that, for such plans, future salary progression must be considered in determining current period pension costs. While future salary progression (where appropriate to the plan's benefit formula) must be incorporated (via estimated wage increase rates), current pension cost is a function of the services provided by the employee in the reporting period, emphatically not including services to be provided in later periods.

Under IAS 19, service cost is based on the present value of the defined benefit obligation, and is attributed to periods of service without regard to conditional requirements under the plan calling for further service. Thus, vesting is not taken into account in the sense that there is no justification for non-accrual prior to vesting. However, in the actuarial determination of pension cost, the statistical probability of employees leaving employment prior to vesting must be taken into account, lest an overaccrual of these costs result.

### ***Interest on the accrued benefit obligation***

As noted, since the actuarial determination of current period cost is the present value of the future pension benefits to be paid to retirees by virtue of their service in the current period, the longer the time until the expected retirement date, the lower will be the service cost recognized. However, over time this accrued cost must be further increased, until at the employees' respective retirement dates the full amounts of the promised payments have been accreted. In this regard, the accrued pension liability is much like a sinking fund that grows from contributions plus the earnings thereon.

While service cost and interest are often the major components of expense recognized in connection with defined benefit plans, there are other important elements of benefit cost to be accounted for. IAS 19 identifies the expected return on plan assets, actuarial gains and losses, past service costs, and the effects of any curtailments or settlements as categories to be

explicitly addressed in the disclosure of the details of annual pension cost for defined benefit plans. These will be discussed in the following sections, in turn.

### ***The expected return on plan assets***

IAS 19 has adopted the approach that since pension plan assets are intended as long-term investments, the random and perhaps sizable fluctuations from period to period should not be allowed to excessively distort the operating results reported by the sponsoring entity. This standard identifies the expected return rather than the actual return on plan assets as the salient component of pension cost, with the difference between actual and expected return being an *actuarial gain or loss* to be dealt with as described below. Expected return for a given period is determined at the same rate that the discount rate applied to determine the defined benefit pension obligation.

The IAS 19 amendment adopted in 2000 also added certain new requirements which relate to recognition and measurement of the right of reimbursement of all or part of the expenditure to settle a defined benefit obligation. It established that only when it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, the sponsoring entity would recognize its right to reimbursement as a separate asset, which would be measured at fair value. In all other respects, however, the asset (amount due from the pension plan) is to be treated in the same way as plan assets. In the statement of profit or loss and other comprehensive income or separate income statement presented, defined benefit plan expense may be presented net of the reimbursement receivable recognized.

In some situations, a plan sponsor would be able to look to another entity to pay some or all of the cost to settle a defined benefit obligation, but the assets held by that other party were not deemed to be plan assets as defined in IAS 19 (prior to the revision in 2000). For example, when an insurance policy would match post-employment benefits, the assets of the insurer were not included in plan assets because the insurer was not established solely to pay or fund employee benefits. In such cases, the sponsor recognized its right to reimbursement as a separate asset, rather than as a deduction in determining the defined benefit liability (i.e., no right of offset was deemed to exist in such instances); in all other respects the sponsoring entity would treat that asset in the same way as plan assets. A brief description of the link between the reimbursement and the related obligation would be required.

If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement was formerly deemed to be present value of the related obligation (subject to any reduction required if the reimbursement was not recoverable in full).

As amended, however, qualifying insurance policies are now to be included in plan assets, arguably because those plans have similar economic effects to funds whose assets qualify as plan assets under the revised definition.

### ***Actuarial gains and losses***

Changes in the amount of the actuarially determined pension obligation, and differences in the actual versus the expected return on plan assets, as well as demographic changes (e.g., composition of the workforce, changes in life expectancy, etc.) contribute to actuarial (or “experience”) gains and losses and are immediately recognized in other comprehensive

income, without deferral or any off-balance-sheet treatment previously permitted under the “corridor approach.”

### ***Past service costs***

Past service costs refer to increases in the amount of a defined benefit liability that results from the initial adoption of a plan, or from a change or amendment to an existing plan which increases the benefits promised to the participants with respect to previous service rendered. Less commonly, a plan amendment could reduce the benefits for past services, if local laws permit this. Employers will amend plans for a variety of reasons, including competitive factors in the employment marketplace, but often it is done with the hope and expectation that it will engender goodwill among the workers and thus increase future productivity. For this reason, it is sometimes the case that these added benefits will not vest immediately, but rather must be earned over some defined time period.

IAS 19 requires immediate recognition of past service costs when they occur as a result of a plan amendment, curtailment or settlement as the case may be.

Settlements occur when the entity enters into a transaction which effectively transfers the obligation to another entity, such as an insurance company, so that the sponsor has no legal or constructive obligation to fund any benefit shortfall. Merely acquiring insurance which is intended to cover the benefit payments does not constitute a settlement, since a funding mechanism does not relieve the underlying obligation.

### ***Transition adjustment***

Where an entity has to change its accounting policy to bring these accounting requirements into effect it shall do so on a fully retroactive basis. However, an entity need not adjust the carrying amount of assets outside the scope of IAS 19 for changes in employee benefit costs that were included in the carrying amount before the date of initial application. The date of initial application is the beginning of the earliest prior period presented in the first financial statements in which the entity adopts this standard.

## **EMPLOYER’S LIABILITY AND ASSETS**

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IAS 19 requires that a defined benefit liability or asset be included in the sponsor’s statement of financial position when certain conditions are met. Specifically, under the provisions of IAS 19, the amount recognized as a defined benefit liability in the employer’s statement of financial position is the net total of:

1. The present value of the defined benefit obligation at the end of the reporting period;
2. The fair value of plan assets at the end of the reporting period.

If this amount nets to a negative sum, it represents the defined benefit asset to be reported in the employer’s statement of financial position. However, the amount of asset that can be displayed, per IAS 19, is subject to a *ceiling requirement*.

The asset ceiling defined in IAS 19 is the lower of:

1. The amount computed in the preceding paragraph; or
2. The total of the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan, determined using the discount rate applied to determine the present value of the defined benefit liability obligation.



## MINIMUM FUNDING REQUIREMENT

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### **IFRIC 14: IAS 19—*The Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction***

In July 2007, IFRIC issued Interpretation 14 to provide guidance on the limitation on asset recognition and the statutory minimum funding requirements. IFRIC 14 was amended November 2009, effective for annual periods beginning on or after January 1, 2011. The amendment is applicable to limited circumstances where an entity is subject to minimum funding requirements and makes an early payment of contributions to cover the funding requirements. The benefit of such an early payment is regarded as an asset.

According to IASB, the interaction of this limit and minimum funding requirement has two possible effects:

1. The minimum funding requirement may restrict the economic benefits available as a reduction in future contributions; and
2. The limit may make the minimum funding requirement onerous because contributions payable under the requirement for services already received may not be available once they have been paid, either as a refund or as a reduction in future contributions.

In some jurisdictions, there are statutory (or contractual) minimum funding requirements that require sponsors to make future contributions. This is an increasingly common phenomenon, given the public's growing awareness that many defined benefit plans have been underfunded, raising concerns that retirees will find insufficient assets to pay their benefits after, for example, the plan sponsor has ceased operations or been sold. The question raised was whether those requirements should limit the amount of plan assets the employer may report in its statement of financial position in those situations where application of IAS 19 would otherwise permit asset recognition, as discussed in the preceding paragraphs. In other words, the problem was that the IAS 19-based asset might not be available to the entity (and thus not be an asset of the reporting entity) in certain situations where future minimum funding requirements exist.

IFRIC 14 addresses the extent to which the economic benefit, via refund or reduction in future contributions, is constrained by contractual or statutory minimum funding obligations. It also addresses the calculation of the available benefits under such circumstances, as well as the effect of the minimum funding requirement on the measurement of defined benefit plan asset or liability.

IFRIC 14 addresses the following issues:

1. When refunds or reductions in future contributions should be regarded as “available to the employer.”
2. The economic benefit available as a reduction in future contributions.
3. The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions.
4. When a minimum funding requirement may give rise to a liability.

#### ***Economic benefit available as a refund***

IFRIC 14 specifies that the availability of a refund of a surplus or a reduction in future contributions would be determined in accordance with the terms and conditions of the

plan and any statutory requirements in its jurisdiction. An economic benefit, in the form of a refund of surplus or a reduction in future contributions, would be deemed available (and hence an asset of the sponsor) if it will be realizable at some point during the life of the plan or when the plan liabilities are finally settled. Most importantly, an economic benefit, in the form of a refund from the plan or reduction in future contributions, may still be deemed available even if it is not realizable immediately at the end of the reporting period, as long as the refunds from the plan will be realizable during the life of a plan or at final settlement.

In cases where the question to be resolved is the amount of asset that is deemed to be an economic benefit to be received via a refund, this is to be measured as the amount that will be refunded to the entity *either*:

1. During the life of the plan, without assuming that the plan liabilities have to be settled in order to get the refund (e.g., in some jurisdictions, the entity may have a contractual right to a refund during the life of the plan, irrespective of whether the plan liability is settled); or
2. Assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or
3. Assuming the full settlement of the plan liabilities in a single event (i.e., as a plan termination and settlement).

The amount of the economic benefit is to be determined on the basis of the approach that is the *most advantageous* to the entity. It is thus to be measured as the amount of the surplus (i.e., the fair value of the plan assets less the present value of the defined benefit obligation) that, at the end of the reporting period, the reporting entity has a right to receive as a refund after all the associated costs (such as taxes other than those on income) are paid.

If the refund is calculated using the approach in subparagraph (3) above, then the costs associated with the settlement of the plan liabilities and making the refund are to be taken into account. These could include professional fees to be paid by the plan, as well as the costs of any insurance premiums that might be required to secure the liability upon plan settlement.

Since under IAS 19 the surplus at the end of the reporting period is measured at present value, even if the refund is realizable only at a future date no further adjustment will need to be made for the time value of money.

#### ***Economic benefit available as a reduction in future contributions***

When there is no minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity. The future service cost to the entity excludes amounts borne by employees.

IFRIC 14 requires that, in accordance with IAS 1, the entity disclose information about the key sources of estimation uncertainty at the end of the reporting period, if there is a significant risk of material adjustment to the carrying amount of the net asset or liability in the statement of financial position. This might include disclosure of any restrictions on the current realizability of the plan assets, or disclosure of the basis used to determine the amount of the economic benefit available as a refund.



***The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions***

In cases where there is a minimum funding requirement, the question to be resolved is the amount of asset that is deemed to be an economic benefit to be received via a future contribution reduction using IAS 19 assumptions applicable at the end of the reporting period. The amount is the sum of:

1. Any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment; and
2. The estimated future service cost in each period (excluding any part of the total cost that is borne by employees); *less*
3. Any future minimum funding requirement contribution that would be required for future service in those periods if no prepayment as described in 1. is applicable.

Any expected changes in the future minimum funding contributions as a result of the entity paying the minimum contributions due would be reflected in the measurement of the available contribution reduction. However, no allowance could be made for expected changes in the terms and conditions of the minimum funding requirement that are not substantively enacted at the end of the reporting period. Any allowances for expected future changes in the demographic profile of the workforce would have to be consistent with the assumptions underlying the calculation of the present value of the defined benefit obligation itself at the end of the reporting period.

If the future minimum funding requirement contribution for future service exceeds the future IAS 19 service cost in any given period, the excess would be used to reduce the amount of the economic benefit available as a future contribution reduction. The amount of the total asset available as a reduction in future contributions (point 2. above) can never be less than zero.

***When a minimum funding requirement may give rise to a liability***

If an entity has a statutory or contractual obligation under a minimum funding requirement to pay additional contributions to cover an existing shortfall on the minimum funding requirements in respect of services already received by the end of the reporting period, the entity would have to ascertain whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan. To the extent that the contributions payable will not be available once paid into the plan, the reporting entity would be required to recognize a liability. The liability would reduce the defined benefit asset or increase the defined benefit liability when the obligation arises, so that no gain or loss results when the contributions are later paid.

The adjustment to the defined benefit asset or liability in respect of the minimum funding requirement, and any subsequent remeasurement of that adjustment, would be recognized immediately in other comprehensive income as a remeasurement.

IFRIC 14 provides a number of examples illustrating how to calculate the economic benefit available or not available when an entity has a certain funding level on the minimum funding requirement.

## OTHER PENSION CONSIDERATIONS

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### *Multiple and multiemployer plans*

If an entity has more than one plan, IAS 19 provisions should be applied separately to each plan. Offsets or eliminations are not allowed unless there clearly is the right to use the assets in one plan to pay the benefits of another plan.

Participation in a multiemployer plan (to which two or more unrelated employers contribute) requires that the contribution for the period be recognized as net pension cost and that any contributions due and unpaid be recognized as a liability. Assets in this type of plan are usually commingled and are not segregated or restricted. A board of trustees usually administers these plans, and multiemployer plans are generally subject to a collective bargaining agreement. If there is a withdrawal from this type of plan and if an arising obligation is either probable or reasonably possible, the provisions of IFRS that address contingencies (IAS 37) apply.

Some plans are, in substance, a pooling or aggregation of single employer plans and are ordinarily without collective bargaining agreements. Contributions are usually based on a selected benefit formula. These plans are not considered multiemployer plans, and the accounting is based on the respective interest in the plan.

### *Business combinations*

When an entity that sponsors a single-employer defined benefit plan is acquired and must therefore be accounted for under the provisions of IFRS 3 (revised 2008), the purchaser should assign part of the purchase price to an asset if plan assets exceed the projected benefit obligation, or to a liability if the projected benefit obligation exceeds plan assets. The projected benefit obligation should include the effect of any expected plan curtailment or termination. This assignment eliminates any existing unrecognized components, and any future differences between contributions and net pension cost will affect the asset or liability recognized when the purchase took place.

### *Contributions from employees or third parties*

The November 2013 amendment, applicable for accounting periods starting on or after July 1, 2014 requires contributions from employees or third parties, set out in the formal terms of the plan to be first determined as whether it reduced the cost of benefit to the entity or these are in the nature of reimbursement rights. In the case of reimbursement rights, it is to be dealt with as explained in other sections in this chapter.

In respect of those which are in the nature of reducing the cost of benefit to the entity:

- (a) Reduce service cost, if they are linked to service; or
- (b) Affect remeasurements of the net defined benefit liability (asset) if they are not linked to service (for instance, a contribution to reduce a deficit arising from losses on plan assets or from actuarial losses).

Where contributions from employees and third parties are linked to service, they reduce the service cost:

- (a) If the contribution is dependent on the number of years of service, then it shall be attributed to the periods of service using the same attribution method as applied to the gross benefit. Changes in such contributions result in:
  - a. Current and past service costs (where those changes are not set out in the formal terms of a plan and do not arise from a constructive obligation); or

- b. actuarial gains and losses (where those changes are set out in the formal terms of a plan or arise from a constructive obligation).
- (b) If the contribution is independent of the number of years' service (such as a fixed percentage of employee's salary, a fixed amount throughout the period, an amount linked to the age of the employee etc.), then the entity is to recognize such contributions as a reduction in the service cost in the period when related services are rendered.

## **DISCLOSURES FOR POST-EMPLOYMENT BENEFIT PLANS**

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For defined contribution plans, IAS 19 requires only that the amount of expense included in current period earnings be disclosed. Good practice would suggest that disclosure be made of the general description of each plan, identifying the employee groups covered, and of any other significant matters related to retirement benefits that affect comparability with the previous period reported on.

For defined benefit plans, as would be expected, much more expansive disclosures are mandated. These include:

1. A general description of each plan identifying the employee groups covered.
2. The accounting policy regarding recognition of actuarial gains or losses.
3. A reconciliation of the plan-related assets and liabilities recognized in the statement of financial position, showing at the minimum:
  - a. The present value of wholly unfunded defined benefit obligations.
  - b. The present value (gross, before deducting plan assets) of wholly or partly unfunded obligations.
  - c. The fair value of plan assets.
  - d. Any amount not recognized as an asset because of the limitation to the present value of economic benefits from refunds and future contribution reductions.
  - e. The amounts which are recognized in the statement of financial position.
4. The amount of plan assets represented by each category of the reporting entity's own financial instruments or by property which is occupied by, or other assets used by, the entity itself.
5. A reconciliation of movements (i.e., changes) during the reporting period in the net asset or liability reported in the statement of financial position.
6. The amount of, and location in profit or loss of, the reported amounts of current service cost, net interest cost (income), remeasurements, past service cost, and effect of any curtailment or settlement.
7. The actual return earned on plan assets for the reporting period.
8. The principal actuarial assumptions used, including (if relevant) the discount rates, expected rates of return on plan assets, expected rates of salary increases or other index or variable specified in the pension arrangement, medical cost trend rates, and any other material actuarial assumptions utilized in computing benefit costs for the period. The actuarial assumptions are to be explicitly stated in absolute terms, not merely as references to other indices.
9. A sensitivity analysis on the significant actuarial assumptions.
10. A description of the risks and characteristics of the defined benefit plans.

Amounts presented in the sponsor's statement of financial position cannot be offset (presented on a net basis) unless legal rights of offset exist. Furthermore, even with a legal right to offset (which itself would be a rarity), unless the intent is to settle on a net basis, such presentation would not be acceptable. Thus, a sponsor having two plans, one being in a net asset position, and another in a net liability position, cannot net these in most instances.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

### 30. Employee benefit schemes

The group pension arrangements are operated through a defined contribution scheme and a group defined benefit scheme.

#### Defined contribution schemes

	20XX	20XX-1	
Amount recognized as an expense	X	X	IAS19 p53

#### Defined benefit schemes

The Exemplum Reporting Pension is a final salary pension plan operating for qualifying employees of the group. The plan is governed by the employment laws of (Country). The level of benefits provided depends on members' length of service and salary at retirement age. The fund is governed by a Board of Trustees which compromise of an equal number of employee and employer representatives. The Board is responsible for the investment strategy with regard to the assets of the fund. The pension plan is exposed to (X Country's) inflation, interest rate risk, investment risk, salary risk and changes in the life expectancy for pensioners.

IAS19 p138  
p139

**The amounts recognized in the statement of financial position are as follows:**

IAS19 p10

	<b>Defined benefit pension plans</b>	
	20XX	20XX-1 (Restated)
Present value of funded obligations	X	X
Fair value of plan assets	X	X
Funded status	X	X
Present value of unfunded obligations	X	X
Impact of minimum funding requirement or asset ceiling	X	X
<b>Liability arising from defined benefit obligation</b>	<b>X</b>	<b>X</b>
Amounts in the statement of financial position	X	X
Liabilities	X	X
Assets	X	X
<b>Net liability</b>	<b>X</b>	<b>X</b>

The amounts recognized in profit or loss are as follows:

IAS19 p120  
p135

	<b>Defined benefit pension plans</b>	
	<b>20XX</b>	<b>20XX-1 (Restated)</b>
Current service cost	X	X
Past service cost	X	X
Net interest expense	X	X
Subtotal included in profit or loss	X	X
<i>Re-measurement gains or losses</i>		
Return on plan assets (excluding amounts included in net interest expense)	X	X
Actuarial changes arising from:		
Changes in demographic assumptions	X	X
Changes in financial assumptions	X	X
Experience adjustments	X	X
Adjustments for restrictions of the defined benefit asset	X	X
Subtotal included in other comprehensive income	X	X
Total	X	X

Of the expense for the year, £ X (20XX-1: £ X), has been included is cost of sales and administrative expense. The re-measurement of the net defined benefit liability is included in other comprehensive income.

Changes in the present value of the defined benefit obligation are as follows:

	<b>Defined benefit pension plans</b>		IAS19 p141
	<b>20XX</b>	<b>20XX-1 (Restated)</b>	
Opening defined benefit obligation	X	X	
Service cost	X	X	
Interest cost	X	X	
<b>Actuarial losses (gains) arising from:</b>			
Changes in demographic assumptions	X	X	
Changes in financial assumptions	X	X	
Experience adjustments	X	X	
Losses (gains) on curtailments	X	X	
Liabilities extinguished on settlements	X	X	
<b>Liabilities assumed in a business combination</b>			
Exchange differences on foreign plans	X	X	
Benefits paid	X	X	
Closing defined benefit obligation	X	X	

Changes in the fair value of plan assets are as follows:

IAS19 p141

	Defined benefit pension plans	
	20XX	20XX-1 (Restated)
Opening fair value of plan assets	X	X
Interest income	X	X
Re-measurement gains/(losses): Return on plan assets (excluding amounts included in net interest expense)	X	X
Assets distributed on settlements	X	X
Contributions by employer	X	X
Assets acquired in a business combination	X	X
Exchange differences on foreign plans	X	X
Benefits paid	X	X
<b>Closing fair value of plan assets</b>	<b>X</b>	<b>X</b>

The fair value of the plan assets at the end of the reporting period for each category is as follows:

	20XX	20XX-1	IAS19 p142
Cash and cash equivalents	X	X	
Equity investments by industry type			
Manufacturing industry	X	X	
Financial institutions	X	X	
Debt investments by issuers credit rating			
AAA	X	X	
BB and lower	X	X	
Property investments by geographic location			
Country A	X	X	
Country B	X	X	
Derivatives	X	X	
Other	X	X	
<b>Total</b>	<b>X</b>	<b>X</b>	

The fair value of the above is based on quoted market prices in active markets.

The pension plan assets include ordinary shares issued by Exemplum Reporting plc with a fair value of £ X (20XX-1: £ X). Plan assets also include property occupied by Exemplum Reporting plc with a fair value of £ X (20XX-1: £ X). IAS19 p143

Principal assumptions used for the purposes of the actuarial valuations at the statement of financial position date (expressed as weighted averages): IAS19 p144

	20XX	20XX-1
Discount rate at 31 December	X%	X%
Expected return On plan assets at 31 December	X%	X%
Future salary increases	X%	X%
Future pension increases	X%	X%
Proportion of employees opting for early retirement	X%	X%

Investigations have been carried out within the past three years into the mortality experience of the group's schemes. These investigations concluded that the current mortality assumptions include sufficient allowance for future improvements in mortality rates. The assumed life expectations on retirement at age 65 are: IAS19 p144

	20XX	20XX-1
<b>Retiring today:</b>		
Males	X	X
Females	X	X
<b>Retiring in 20 years:</b>		
Males	X	X
Females	X	X

A sensitivity of the defined benefit obligation to changes in the weighted principal assumptions are shown below: IAS19 p145

	Increase in assumption		Decrease in assumption	
	Percentage or Years	Impact on defined benefit obligation	Percentage or Years	Impact on defined benefit obligation
<b>Discount rate</b>	X%	X	X%	X
<b>Salary growth rate</b>	X%	X	X%	X
<b>Pension growth rate</b>	X%	X	X%	X
<b>Life expectancy of male pensioners</b>	X years	X	X years	X
<b>Life expectancy of female pensioners</b>	X years	X	X years	X

The above sensitivity analyses are based on reasonably possible changes in the principal assumptions occurring at the end of the reporting period, while holding all other assumptions constant. In practice it is unlikely that the change in assumptions would occur in isolation, as some of the assumptions may be correlated.

When calculating the sensitivity of the defined benefit obligation, the present value of the defined benefit obligation has been calculated using the project unit credit method at the end of the reporting period, which is consistent with the calculation of the defined benefit obligation liability recognized in the statement of financial position.

There was no change in the methods and assumptions used in preparing the sensitivity analysis compared to prior years.

Each year a review of the asset-liability matching strategy and investment risk management policy is performed. Contribution policies are based on the results of this review. The aim is to have a portfolio mix of x% equity, x% property and x% debt instruments. IAS19 p146

There has been no change in the process used to manage its risks from prior years.

Funding levels are monitored on an annual basis and the current agreed contribution rate is fixed at x% of pensionable salary. The funding requirements are based on an actuarial valuation. IAS19 p147

The group expects to contribute £ X to its defined benefit pension plans in 20XX.

The weighted average duration of the defined benefit plan obligation at the end of the reporting period is X years (20XX-1: X years).

## OTHER EMPLOYEE BENEFITS

### *Short-term employee benefits*

According to IAS 19, short-term benefits are those falling due within 12 months from the end of the period in which the employees render their services. These include wages and salaries, as well as short-term compensated absences (vacations, annual holiday, paid sick days, etc.), profit sharing and bonuses if due within 12 months after the end of the period in which these were earned, and such non-monetary benefits as health insurance and housing or automobiles. The standard requires that these be reported as incurred. Since they are accrued currently, no actuarial assumptions or computations are needed and, since due currently, discounting is not to be applied.

Compensated absences may provide some accounting complexities, if they accumulate and vest with the employees. Accumulated benefits can be carried forward to later periods when not fully consumed currently; for example, when employees are granted two weeks' leave per year, but can carry forward to later years an amount equal to no more than six weeks, the compensated absence benefit can be said to be subject to limited accumulation. Depending on the program, accumulation rights may be limited or unlimited; and, furthermore, the usage of benefits may be defined to occur on a last-in, first-out (LIFO) basis, which in conjunction with limited accumulation rights further limits the amount of benefits which employees are likely to use, if not fully used in the period earned.

The cost of compensated absences should be accrued in the periods earned. In some cases it will be understood that the amounts of compensated absences to which employees are contractually entitled will exceed the amount that they are likely to actually utilize. In such circumstances, the accrual should be based on the *expected* usage, based on past experience and, if relevant, changes in the plan's provisions since the last reporting period.

#### **Example of compensated absences**

Consider an entity with 500 workers, each of whom earns two weeks' annual leave, with a carryforward option limited to a maximum of six weeks, to be carried forward no longer than four years. Also, this employer imposes a LIFO basis on any usages of annual leave (e.g., a worker with two weeks' carryforward and two weeks earned currently, taking a three-week leave, will be deemed to have consumed the two currently earned weeks plus one of the carryforward weeks, thereby increasing the risk of ultimately losing the older carried-forward compensated absence time). Based on past experience, 80% of the workers will take no more than two weeks' leave in any year, while the other 20% take an average of four extra days. At the end of the year, each worker has an average of five days' carryforward of compensated absences. The amount accrued should be the cost equivalent of  $[(.80 \times 0 \text{ days}) + (.20 \times 4 \text{ days})] \times 500 \text{ workers} = 400 \text{ days' leave}$ .

### *Other post-retirement benefits*

Other post-retirement benefits include medical care and other benefits offered to retirees partially or entirely at the expense of the former employer. These are essentially defined benefit plans very much like defined benefit pension plans. Like the pension plans, these require the services of a qualified actuary in order to estimate the true cost of the promises made currently for benefits to be delivered in the future. As with pensions, a variety of determinants, including the age composition, life expectancies and other demographic



factors pertaining to the present and future retiree groups, and the course of future inflation of medical care (or other covered) costs (coupled with predicted utilization factors), need to be projected in order to compute current period costs. Developing these projections requires the skills and training of actuaries; the projected pattern of future medical costs has been particularly difficult to achieve with anything approaching accuracy. Unlike most defined benefit pension plans, other post-retirement benefit plans are more commonly funded on a pay-as-you-go basis, which does not alter the accounting but does eliminate earnings on plan assets as a cost offset.

### ***Other long-term employee benefits***

These are defined by IAS 19 as including any benefits other than post-employment benefits (pensions, retiree medical care, etc.), termination benefits and equity compensation plans. Examples would include sabbatical leave, “jubilee” or other long-service benefits, long-term profit-sharing payments, and deferred compensation arrangements. Executive deferred compensation plans have become common in nations where these are tax-advantaged (i.e., not taxed to the employee until paid), and these give rise to deferred tax accounting issues as well as measurement and reporting questions, as benefit plans. In general, measurement will be less complex than for defined benefit pension or other post-retirement benefits, although some actuarial measures may be needed.

IAS 19 requires that past service cost (resulting from the granting of enhanced benefits to participants on a retroactive basis) must be reported in profit or loss in the period in which these are granted or occur.

For liability measurement purposes, IAS 19 stipulates that the present value of the obligation be presented in the statement of financial position, less the fair value of any assets that have been set aside for settlement thereof. The long-term corporate bond rate is used here, as with defined benefit pension obligations, to discount the expected future payments to present value. As to expense recognition, the same cost elements as are set forth for pension plan expense should be included, with the exceptions that, as noted, actuarial gains and losses and past service cost must be recognized immediately, not amortized over a defined time horizon.

### ***Termination benefits***

Termination benefits are to be recognized at the earlier of when the entity can no longer withdraw the offer of those benefits, and when the entity recognizes costs for a restructuring that is within the scope of IAS 37.

Since termination benefits do not confer any future economic benefits on the employing entity, these must be expensed immediately.

## **FUTURE DEVELOPMENTS**

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No further specific developments to report.

## **US GAAP COMPARISON**

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Differences exist related to defined benefit plans.

US GAAP employs different actuarial methods, depending on the characteristics of the plan’s benefit formula.

Under US GAAP, as a result of an election by the entity, actuarial gains and losses are recognized in net income as they occur or deferred through a “corridor” approach, that is if the gain or loss exceeds 10% of obligation or asset. Past service costs are initially deferred in other comprehensive income and subsequently recognized in net income, amortized over average remaining service period of active employees or average remaining life expectancy of inactive participants.

The calculation of the expected return on plan assets is based on either the plan assets’ fair value or a value that smoothes the effect of short-term market fluctuations over five years.

Under US GAAP, anticipating changes in the law that would affect variables such as state medical or social security benefits is expressly prohibited. Differences also exist related to termination benefits. US GAAP differentiates between special termination benefits (which are offered for a short time in exchange for employees’ voluntary termination of service) and contractual termination benefits.

Special termination benefits are expensed when employees accept and amount can be estimated; recognize contractual benefits when it is probable that employees will accept and the amount is reasonably estimable.

US GAAP requires that non-retirement post-employment benefits provided to former or inactive employees, their beneficiaries, and covered dependents are accounted for consistent with compensated absences if certain criteria are met. Otherwise, a loss is accrued if it is probable and reasonably estimable.

US GAAP contains no explicit guidance on whether to discount post-employment liabilities and at what rate.

diverse forms of revenue and of possible recognition strategies that could be encountered. The basic principle is that revenue should be measured at the fair value of the consideration that has been received when the product or service promised has been provided to the customer. Specific guidance applies to various categories of revenues.

Thus, in the normal sale of goods, revenue is presumed to have been realized when the significant risks and rewards have been transferred to the buyer, accompanied by the forfeiture of effective control by the seller, and the amount to be received can be reliably measured. For most routine transactions (e.g., by retail merchants), this occurs when the goods have been delivered to the customer.

Revenue recognition for service transactions, as set forth in IAS 18, requires that the percentage-of-completion method be used unless certain defined conditions are not met. Current revenue recognition standards for services transactions closely parallel those for construction contracts under IAS 11, which is also covered in this chapter.

For interest, royalties and dividends, recognition is warranted when it is probable that economic benefits will flow to the entity. Specifically, interest is recognized on a time proportion basis, taking into account the effective yield on the asset. Royalties are recognized on an accrual basis, in accordance with the terms of the underlying agreement. Dividend income is recognized when the shareholder's right to receive payment has been established.

While the existing general guidance on revenue recognition under IAS actually exceeds that which has thus far been provided under various national standards, it nonetheless is modest given the broad importance of the topic.

#### Sources of IFRS

<i>IASB's Framework for Preparation and Presentation of Financial Statements</i>		
<i>IAS 11,18</i>	<i>SIC 31</i>	<i>IFRIC 12, 13, 15, 18</i>

## DEFINITIONS OF TERMS

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**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Ordinary activities.** Those activities of an entity which it undertakes as part of its business and such related activities in which the entity engages in furtherance of, incidental to, or arising from those activities.

**Revenue.** Gross inflow of economic benefits during the period resulting from an entity's ordinary activities is considered "revenue," provided those inflows result in increases in equity, other than increases relating to contributions from owners or equity participants. Revenue refers to the gross amount (of revenue) and excludes amounts collected on behalf of third parties (such as taxes and other transactions where the entity is acting as an agent).

## SCOPE

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### *Revenue*

The IASB's *Framework* defines "income" to include both revenue and gains. IAS 18 deals only with revenue. Revenue is defined as income arising from the ordinary activities of

an entity and may be referred to by a variety of names including sales, fees, interest, dividends and royalties. Revenue encompasses only the gross inflow of economic benefits received or receivable by the entity, on its own account. This implies that amounts collected on behalf of others—including such items as sales tax or value added tax, which also flow to the entity along with the revenue from sales—do not qualify as revenue. Thus, these other collections should not be included in an entity's reported revenue. Put another way, gross revenue from sales should be shown net of amounts collected on behalf of third parties.

Similarly, in an agency relationship the amounts collected on behalf of the principal is not regarded as revenue for the agent. Instead, the commission earned on such collections qualifies as revenue of the agent. For example, in the case of a travel agency, the collections from ticket sales do not qualify as revenue or income from its ordinary activities. Instead, it will be the commission on the tickets sold by the travel agency that will constitute that entity's gross revenue.

### *Scope of the standard*

IAS 18 applies to the accounting for revenue arising from:

- The sale of goods;
- The rendering of services; and
- The use of the entity's assets by others, yielding (for the entity) interest, dividends and royalties.

A sale of goods encompasses *both* goods produced by the entity for sale to others and goods purchased for resale by the entity. The rendering of services involves the performance by the entity of an agreed-upon task, based on a contract, over a contractually agreed period of time.

The use of the entity's assets by others gives rise to revenue for the entity in the form of:

- **Interest**, which is a charge for the use of cash and cash equivalents or for amounts due to the entity;
- **Royalties**, which are charges for the use of long-term assets of the entity such as patents or trademarks owned by the entity; and
- **Dividends**, which are distributions of profit to the holders of equity investments in the share capital of other entities.

The standard *does not* apply to revenue arising from:

- Lease agreements that are subject to the requirements of IAS 17;
- Dividends arising from investments in associates which are accounted for using the equity method, which are dealt with in IAS 28;
- Insurance contracts within the scope of IFRS 4;
- Changes in fair values of financial instruments—or their disposal, which is addressed by IAS 39;
- Natural increases in herds, agriculture and forest products, which are dealt with under IAS 41;
- The extraction of mineral ores; and
- Changes in the value of other current assets.

## IDENTIFICATION

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While setting out clearly the criteria for the recognition of revenue under three categories—sale of goods, rendering of services and use of the entity’s assets by others—the standard clarifies that these should be applied separately to each transaction. In other words, the recognition criteria should be applied to the separately identifiable components of a single transaction consistent with the principle of “substance over form.”

For example, a washing machine is sold with an after-sale service warranty. The selling price includes a separately identifiable portion attributable to the after-sale service warranty. In such a case, the standard requires that the selling price of the washing machine should be apportioned between the two separately identifiable components and each one recognized according to an appropriate recognition criterion. Thus, the portion of the selling price attributable to the after-sales warranty should be deferred and recognized over the period during which the service is performed. The remaining selling price should be recognized immediately if the recognition criteria for revenue from sale of goods (explained below) are satisfied.

Similarly, the recognition criteria are to be applied to two or more separate transactions together when they are connected or linked in such a way that the commercial effect (or substance over form) cannot be understood without considering the series of transactions as a whole. For example, Company X sells a ship to Company Y and later enters into a separate contract with Company Y to repurchase the same ship from it. In this case the two transactions need to be considered together in order to ascertain whether or not revenue is to be recognized.

## MEASUREMENT

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The quantum of revenue to be recognized is usually dependent upon the terms of the contract between the entity and the buyer of goods, the recipient of the services, or the users of the assets of the entity. Revenue should be measured at the fair value of the consideration received or receivable, net of any trade discounts and volume rebates allowed by the entity.

When the inflow of the consideration, which is usually in the form of cash or cash equivalents, is deferred, the fair value of the consideration will be an amount lower than the nominal amount of consideration. The difference between the fair value and the nominal value of the consideration, which represents the time value of money, is recognized as interest revenue over the period of deferral.

When the entity offers interest-free extended credit to the buyer or accepts a promissory note from the buyer (as consideration) that bears either no interest or a below-market interest rate, such an arrangement could be construed as a financing transaction. In such a case the fair value of the consideration is ascertained by discounting the future inflows using an imputed rate of interest. The imputed rate of interest is either “the prevailing rate of interest for a similar instrument of an issuer with a similar credit rating, or a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.”

To illustrate this point, let us consider the following example:

Hero International is a car dealership that is known to offer excellent packages for all new models of Japanese cars. Currently, it is advertising on the television that there is a special offer for all Year 2016 models of a certain make. The offer is valid for all purchases made on or before April

30, 2016. The special offer deal is either a cash payment in full of €20,000 or a zero down payment with extended credit terms of two years—24 monthly installments of €1,000 each. Thus, anyone opting for the extended credit terms would pay €24,000 in total.

Since there is a difference of €4,000 between the cash price of €20,000 and the total amount payable if the car is paid for in 24 installments of €1,000 each, this arrangement is effectively a financing transaction (and, of course, a sale transaction as well). The cash price of €20,000 would be regarded as the amount of consideration attributable to the sale of the car. The difference between the cash price and the aggregate amount payable in monthly installments is interest revenue and is to be recognized over the period of two years on a time proportion basis (using the effective interest method).

### ***Exchanges of similar and dissimilar goods and services***

When goods or services are exchanged or swapped for *similar* goods or services, the earning process is not considered as being complete. Thus the exchange is not regarded as a transaction that generates revenue. Such exchanges are common in certain commodity industries, such as the oil or milk industries, where suppliers usually swap inventories in various locations in order to meet geographically diverse demand on a timely basis.

In contrast, when goods or services of a *dissimilar* nature are swapped, the earning process is considered to be complete, and thus the exchange is regarded as a transaction that generates revenue. The revenue thus generated is measured at the fair value of the goods or services received or receivable. If in this process cash or cash equivalents are also transferred, then the fair value should be adjusted by the amount of cash or cash equivalents transferred. In certain cases, the fair value of the goods or services received cannot be measured reliably. Under such circumstances, fair value of goods or services given up, adjusted by the amount of cash transferred, is the measure of revenue to be recognized. Barter arrangements are examples of such exchanges involving goods that are dissimilar in nature.

For further guidance see “Accounting for barter transactions” under “Specific transactions.”

## **RECOGNITION**

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According to the IASB’s *Framework*, revenue is to be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the quantum of revenue is possible. Based on these fundamental principles of revenue recognition stated in the IASB’s *Framework*, IAS 18 establishes criteria for recognition of revenue from three categories of transactions—the sale of goods, the rendering of services, and the use by others of the reporting entity’s assets. In the case of the first two categories of transactions producing revenue, the standard prescribes certain additional criteria for recognition of revenue. In the case of revenue from the use by others of the entity’s assets, the standard does not extensively prescribe additional criteria, but it does provide guidance on the bases to be adopted in revenue recognition from this source. This may, in a way, be construed as an additional criterion for revenue recognition from this source of revenue.

### ***Revenue recognition from the sale of goods***

Revenue from the sale of goods should be recognized if *all* of the five conditions mentioned below are met:

- The reporting entity has transferred significant risks and rewards of ownership of the goods to the buyer;

- The entity does not retain either continuing managerial involvement (related to that usually associated with ownership) *or* effective control over the goods sold;
- The amount of revenue to be recognized can be measured reliably;
- The probability that economic benefits related to the transaction will flow to the entity exists; and
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

The determination of the point in time when a reporting entity is considered to have transferred the significant risks and rewards of ownership in goods to the buyer is critical to the recognition of revenue from the sale of goods. If upon examination of the circumstances of the transfer of risks and rewards of ownership by the entity it is determined that the entity could still be considered as having retained significant risks and rewards of ownership, the transaction could not be regarded as a sale.

Some examples of situations illustrated by the standard in which an entity may be considered to have retained significant risks and rewards of ownership, and thus preclude revenue recognition, are when there is some degree of uncertainty around the transaction. Examples include:

- A contract for the sale of an oil refinery stipulates that installation of the refinery is an integral and a significant part of the contract. Therefore, until the refinery is completely installed by the reporting entity that sold it, the sale would not be regarded as complete. In other words, until the completion of the installation, the entity that sold the refinery would still be regarded as the effective owner of the refinery even if the refinery has already been delivered to the buyer. Accordingly, revenue will not be recognized by the entity until it completes the installation of the refinery.
- Goods are sold on approval, whereby the buyer has negotiated a limited right of return. If there is uncertainty about the possibility of return, revenue is not recognized until the shipment has been formally accepted by the buyer, or the goods have been delivered as per the terms of the contract, and the time stipulated in the contract for rejection has expired.
- In the case of “layaway sales,” under terms of which the goods are stored at the supplier’s premises and delivered only when the buyer makes the final payment in a series of installments, revenue is not recognized until the last and final payment is received by the entity. Upon receipt of the final installment, the goods are delivered to the buyer and revenue is recognized. However, based upon experience, if it can reasonably be presumed that most such sales are consummated, revenue may be recognized when a significant deposit is received from the buyer and goods are on hand, identified and ready for delivery to the buyer.

If the reporting entity retains only an insignificant risk of ownership, the transaction is considered a sale and revenue is recognized.

For example, a department store has a policy to offer a refund if a customer is not satisfied. Since the entity is only retaining an insignificant risk of ownership, revenue from sale of goods is recognized. However, since the entity’s refund policy is publicly announced and thus would have created a valid expectation on the part of the customers that the store will honour its policy of refunds, a provision is also recognized for the best estimate of the costs of refunds, as explained in IAS 37.

Another important condition for recognition of revenue from the sale of goods is the existence of the probability that the economic benefits will flow to the entity. For example, for several years an entity has been exporting goods to a foreign country. In the current year, due to sudden restrictions by the foreign government on remittances of currency outside the country, collections from these sales were not made by the entity. The probability of receiving the revenue must be assessed before the revenue could be recognized. Yet another important condition for recognition of revenue from the sale of goods relates to the reliability of measuring costs associated with the sale of goods. Thus, if expenses such as those relating to warranties or other post-shipment costs cannot be measured reliably, then revenue from the sale of such goods should also not be recognized. This rule is based on the principle of matching of revenues and expenses.

The IASB provides additional guidance on determining the point in time at which the entity transfers the significant risks and rewards of ownership, and thus when revenue from sale of goods is to be recognized. Since the law in different countries may determine the point in time at which the entity transfers ownership, this guidance accompanies IAS 18 but is not part of IAS 18. It includes the following:

**Consignment sales.** Revenue is recognized by the shipper (seller or consignor), not by the recipient (buyer or consignee), when the goods are sold to a third party. Goods out on consignment remain the property of the consignor and are included in its inventory.

The consignee is selling the goods on behalf of the shipper for a commission.

**Cash on delivery sales.** In this case, revenue is recognized after delivery of goods is made and cash received.

**Sales to intermediate parties, such as distributors, dealers or others for resale.** In general, revenue is recognized when the risks and rewards of ownership have been transferred. In situations when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale.

**Subscriptions to publications and similar items.** Revenue is recognized on a straight-line basis over the period in which the items are dispatched (when items are of similar value); or on the basis of the sales value of items dispatched to total estimated sales value (when the items vary in value).

**Installment sale, under which the consideration is receivable in installments.** Revenue is recognized at the present value of the consideration, determined by discounting the installments receivable at the imputed rate of interest.

**Real estate sales.** In accordance with IFRIC 15, revenue from the construction of real estate is recognized depending on whether an agreement is for the sale of goods, the rendering of services or a construction contract (within the scope of IAS 11 or IAS 18).

### *Revenue recognition from the rendering of services*

When the outcome of the transaction involving the rendering of services can be estimated reliably, revenue relating to that transaction should be recognized. The recognition of revenue should be with reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when each of the four conditions set out below is met:

- The amount of revenue can be measured reliably;
- The probability that the economic benefits related to this transaction will flow to the entity exists;



- The stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

This manner of recognition of revenue, based on the stage of completion, is often referred to as the “percentage-of-completion” method. IAS 11 also mandates recognition of revenue on this basis. Revenue is recognized only when it is probable that the economic benefits related to the transaction will flow to the reporting entity. However, when the amount of revenue cannot be estimated reliably, revenue should be recognized only to the extent of the expenses recognized that are recoverable (“cost recovery method” is fallback in this case). If there is uncertainty with regard to the collectibility of an amount already included in revenue, the uncollectible amount should be recognized as an expense instead of adjusting it against the amount of revenue originally recognized.

In order to be able to make reliable estimates, an entity should agree with the other party to the following:

- Each other’s enforceable rights with respect to the services provided;
- The consideration to be exchanged; and
- The manner and terms of settlement.

It is important that the entity has in place an effective internal financial budgeting and reporting system. This ensures that the entity can promptly review and revise the estimates of revenue as the service is being performed. It should be noted, however, that merely because there is a later need for revisions does not by itself make an estimate of the outcome of the transaction unreliable.

Progress payments and advances received from customers are emphatically not a measure of stage of completion. The stage of completion of a transaction may be determined in a number of ways. Depending on the nature of the transaction, the method used may include:

- Surveys of work performed;
- Services performed to date as a percentage of total services to be performed; or
- The proportion that costs incurred to date bear to the estimated total costs of the transaction. (Only costs that reflect services performed or to be performed are included in costs incurred to date or in estimated total costs.)

In certain cases services are performed by an indeterminable number of acts over a specified period of time. Revenue in such a case should be recognized on a straight-line basis unless it is possible to estimate the stage of completion by some other method more reliably. Similarly when in a series of acts to be performed in rendering a service, a specific act is much more significant than other acts, the recognition is postponed until the significant act is performed.

During the early stages of the transaction it may not be possible to estimate the outcome of the transaction reliably. In all such cases, where the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognized only to the extent of the expenses recognized that are recoverable. However, in a later period when the uncertainty that precluded the reliable estimation of the outcome no longer exists, revenue is recognized as usual.

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*NOTE: The “percentage-of-completion” method is discussed in detail in the second part of this chapter. For numerical examples illustrating the method, please refer to the second part of this chapter relating to construction contracts.*

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### ***Revenue recognition from interest, royalties and dividends***

Revenue arising from the use by others of the reporting entity’s assets yielding interest, royalties and dividends should be recognized when both of the following two conditions are met:

1. It is probable that the economic benefits relating to the transaction will flow to the entity; and
2. The amount of the revenue can be measured reliably.

The bases prescribed for the recognition of the revenue are the following:

1. In the case of interest—the time proportion basis that takes into account the effective yield on the assets;
2. In the case of royalties—the accrual basis in accordance with the substance of the relevant agreement; and
3. In the case of dividends—when the shareholders’ rights to receive payment are established.

According to IAS 18, “the effective yield on an asset is the rate of interest used to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of asset.” Interest revenue includes the effect of amortization of any discount, premium or other difference between the initial carrying amount of a debt security and its amount at maturity.

When unpaid interest has accrued before an interest-bearing investment is purchased by the entity, the subsequent receipt of interest is to be allocated between preacquisition and post-acquisition periods. Only the portion of interest that accrued subsequent to the acquisition by the entity is recognized as income. The remaining portion of interest, which is attributable to the preacquisition period, is treated as a reduction of the cost of the investment, as explained by IAS 39. Dividends earned from preacquisition profits related to equity securities purchased were previously treated as a reduction of the cost of investment. IFRS was amended to provide that dividends earned are treated as revenue in the year in which they accrue to the investee entity regardless of when the related profits were earned. However, when such a dividend payment is made and there are indicators that the carrying value of the investment may be impaired, the investee must apply IAS 36 in recognizing any impairment loss.

## **SPECIFIC TRANSACTIONS**

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### ***Revenue recognized from the transfer of assets from customers***

In some industries such as the utilities industry and entities that outsource information technology solutions, an entity may receive from its customers items of property, plant and equipment that must be used to connect those customers to a network and/or to provide them with ongoing access to a supply of commodities and services. Alternatively, the supplier entity may receive cash from customers from the acquisition or construction of such items of

property, plant and equipment. Typically, customers will be required to pay additional amounts for the purchase of goods or services based on usage. IFRIC 18, *Transfers of Assets from Customers*, addresses the accounting concerns that exist in this area. The Interpretation is applicable prospectively to transfers of assets from customers received on or after July 1, 2009. The Interpretation allows early application provided the valuations and other information needed to apply the Interpretation to past transfers were obtained at the time those transfers occurred.

IFRIC 18 addresses the following issues:

1. Is the definition of an asset met?
2. If the definition of an asset is met, how should the transferred item of property, plant and equipment be measured on initial recognition?
3. If the item of property, plant and equipment is measured at fair value on initial recognition, how should the resulting credit be accounted for?
4. How should the entity account for a transfer of cash from its customer?

*Definition of an asset:* An asset exists only if the definition of an asset as contained in the *Framework* is met. An asset is defined as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.” In most circumstances, the entity obtains the right of ownership of the transferred item of property, plant and equipment. However, in determining whether an asset exists, the right of ownership is not essential. Therefore, if the customer continues to control the transferred item, the asset definition would not be met despite a transfer of ownership. Before an asset can be recognized, all the facts and circumstances that are pertinent to the arrangement must be considered fully, and should any of the requirements of ownership not be met, an asset cannot be recognized.

*How should the transferred item of property, plant and equipment be measured on initial recognition?* Should the entity conclude that the definition of an asset is met, it will then recognize the transferred asset as an item of property, plant and equipment at its fair value in accordance with IAS 16.

*How should the credit be accounted for?* The resultant credit is recognized in profit or loss in terms of IAS 18. IAS 18 states that “When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue.” In this particular case, there is deemed to be an exchange of dissimilar goods and services and, as such, revenue is generated. The Interpretation also addresses scenarios where the revenue realized is earned from separately identifiable service offerings. In terms of IAS 18, such revenue streams must be recognized separately. An indicator that providing the customer with ongoing access to a supply of goods or services is a separately identifiable service to the entity is when, in the future, the customer making the transfer receives the ongoing access, the goods or services, or both at a price lower than would be charged without the transfer of the item of property, plant and equipment. Conversely, a feature that indicates that the obligation to provide the customer with ongoing access to a supply of goods or services arises from the terms of the entity’s operating license or other regulation rather than from the agreement relating to the transfer of an item of property, plant and equipment is that customers that make a transfer pay the same price as those that do not for the ongoing access, or for the goods or services.

Where the entity identifies a single service, revenue is recognized when the service is provided based on the stage of completion method. The recognition of revenue should

always take into account the obligations placed on the entity by the contract entered into. If more than one separately identifiable service is identified, IAS 18 requires the fair value of the total consideration received or receivable for the agreement to be allocated to each service and the recognition criteria applicable to each component of the contract.

If an ongoing service is identified as part of the agreement, the period over which revenue is recognized for that service is generally determined by the terms of the agreement with the customer. If the agreement does not specify a period, the revenue shall be recognized over a period no longer than the useful life of the transferred asset used to provide the ongoing service.

*How should the entity account for a transfer of cash from its customer?* When an entity receives a transfer of cash from a customer, it should assess whether the agreement entered into is within the scope of the Interpretation. If it is, the entity shall assess whether the constructed or acquired item of property, plant and equipment meets the definition of an asset in accordance with the *Framework* and if the definition is met, the entity should recognize the item of property, plant and equipment at its cost. The entity should also recognize revenue at the fair value of the cash received. Any difference is recorded as a gain or loss in the statement of comprehensive income.

A reporting entity should disclose the following:

- The accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- The amount of each significant category of revenue recognized during the period including revenue arising from:
  - The sale of goods;
  - The rendering of services; and
  - Interest, royalties and dividends;
- The amounts of revenue arising from exchanges of goods or services included in each significant category of revenue.

### ***Accounting for barter transactions***

The much-heralded era of e-commerce (i.e., commerce conducted via Internet, based on commercial websites directed at end consumers [“B-to-C” business] or at intermediate consumers, such as wholesalers and manufacturers [“B-to-B” business]), although past its over-touted boom period, is now an established feature of business life. It is likely that growing percentages of business will be conducted via electronic commerce.

The “dot-com bubble” period was noteworthy for another, related trend, that of investors and others finding value in new “performance” measures such as gross sales volume and the number of “hits” registered on websites. Concurrently, the importance (for high technology and start-up entities in particular) of traditional measures of success, particularly profits, was often unjustifiably discounted. The confluence of these two structural changes provided an unfortunate opportunity for some entities to seek ways to inflate reported revenues, if not actual profits. One device involved barter revenues.

Specifically, it became commonplace for Web-based businesses to swap advertising with each other. With each entity “buying” advertising on others’ sites and “selling” advertising opportunities on its own site to the same counterparties, a liberal interpretation of financial

reporting standards could enable each of them to inflate reported revenues by attributing value to such an exchange. While the corresponding expenses of each of the counterparties were also necessarily exaggerated, so that net earnings were not at all affected (unless revenues and expenses were reported in different fiscal periods, which also occurred), with investors mesmerized by reported gross revenues and the growth thereof, the impact was to encourage overvaluation of the entities' shares in the market.

As certain financial reporting frauds have demonstrated, distortion of revenues via "swap" arrangements has hardly been constrained to the providing and acquiring of internet-based advertising. (For example, "capacity swaps" were employed by many US telecom and energy companies as a device to record immediate revenue, while amortizing the related costs over extended contract periods.) However, the bartering of advertising services came to the attention of the SIC who then issued an Interpretation, SIC 31, to address the matter.

This Interpretation addresses how revenue from a barter transaction involving advertising services received or provided in a barter transaction should be reliably measured. The SIC agreed that the entity providing advertising should measure revenue from the barter transaction based on the fair value of the advertising services it has provided to its customer, and not on the value of that received. In fact, the SIC states categorically that the value of the services received cannot be used to reliably measure the revenue generated by the services provided.

Furthermore, SIC 31 holds that the fair value advertising services provided in a barter transaction can be reliably measured only by reference to non-barter transactions that involve services similar to that in the barter transaction, when those transactions occur frequently, are expected to continue occurring after the barter transaction, represent a predominant source of revenue from advertising similar to the advertising in the barter transaction, involve cash and/or another form of consideration (e.g., marketable securities, non-monetary assets, and other services) that has a reliably determinable fair value, and do not involve the same counterparty as in the barter transaction. All of these conditions must be satisfied in order to value the revenue to be recognized from the advertising barter transaction.

Clearly, based on the criteria mandated by SIC 31, the more common barter transactions, involving mere "swaps" of advertising among the members of the bartering group, henceforth cannot serve as a basis for revenue recognition by any of the parties thereto.

### ***Accounting for multiple-element revenue arrangements***

Presently, IAS 18 lacks guidance on the accounting for multiple-element revenue arrangements, but the IASB's project on revenue recognition does deal with this increasingly common phenomenon. When entities offer customers multiple-element arrangements, these provide for the delivery or performance of multiple products, services or rights, which may take place at different times. For example, deregulation, innovation, and competition in the telecommunication industry resulted in complex service offerings to customers, in particular for bundled (or multiple-element) arrangements that may include a handset. Revenue recognition is one of the most complex accounting issues this industry faces. The IASB has noted that the accounting for such arrangements has been one of the most contentious practice issues of revenue recognition. As part of its current project, it examined the application of an assets and liabilities approach to revenue recognition against the cases involving multiple-element revenue arrangements, and contrasted the impact of such an approach to the positions taken by the FASB's Emerging Issues Task Force's *Accounting for Revenue Arrangements with Multiple Deliverables* (EITF Issue 00-21, which was approved by the EITF in November 2002, now codified as ASC 605-25). The IASB noted that the EITF's

approach was consistent with, but more extensive than, the revenue recognition criteria in IAS 18. We discuss the IASB's Revenue project in more detail at the end of this chapter.

### ***Reporting revenue as a principal or as an agent***

IAS 18 stipulates that, when an entity is acting in the capacity of an agent, its gross inflows of cash or other economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. Since amounts collected on behalf of the principal are not revenue, the reporting entity's revenue should only be the amount of the commissions it receives. To report the gross amounts collected as revenue in such circumstances would exaggerate and greatly distort the scope or scale of the entity's actual operations.

However, determining whether an entity is acting as a principal or as an agent requires the application of judgement and consideration of all relevant facts and circumstances. IFRS previously did not offer any further guidance on making such determinations.

Improvements to IFRS adopted in 2009 provide the guidance required in determining whether an entity is acting as a principal or as an agent. As revised, IAS 18 notes that an entity is acting as a principal when it is exposed to the significant risks and rewards associated with selling goods or rendering services, and that includes having:

1. Primary responsibility for providing the goods or services to the customer or for fulfilling the order;
2. Inventory risk before and after the customer order;
3. Latitude in establishing prices, either directly or indirectly; and
4. Customer's credit risk for the amount receivable from the customer.

On the other hand, an entity is acting as an agent when it is not exposed to the significant risks and rewards associated with selling goods or rendering services, for example, when compensation earned is predetermined based on either a fixed fee per transaction or a stated percentage of the amount billed to the customer. In the latter instances, the gross revenue to be reported is merely the agent's commissions received.

### ***Sales involving customer loyalty credits***

Certain sales transactions involve the granting of so-called customer loyalty credits, such that customers are granted "points" toward future purchases of goods or services. The popular airline mileage programs are perhaps the most ubiquitous of such programs, under which frequent fliers accumulate points which can be redeemed for future class upgrades or free flights. For a long time no special accounting recognition was given to these very real obligations by the airlines, which resulted in a large overhang of costly service promises. These promises clearly represented obligations (i.e., accounting liabilities) by the service providers (e.g., airlines), but were long ignored for two reasons. First, they were assumed to not be material to the service providers' statements of financial position; and second, there were legitimate concerns about how these were to be measured (i.e., whether they should have been recorded at some average of the retail value of the "free" services, or at the providers' cost to provide these services, which were to be delivered at some unspecified future date).

More recently, it had become clear that quite material amounts of such obligations had been going unreported by the service providers, with the cumulative effect of possibly materially overstating current profitability and shareholders' equity (retained earnings) and understating liabilities. In the IFRS arena, this has now been definitively dealt with by the promulgation of IFRIC 13, *Customer Loyalty Programs*. It applies to a wide array of such

programs, including those linked to individual and group buying activities, with goods or services due to be provided by the reporting entity itself as well as rights to be redeemed by third parties. In each such instance, customers earn the right to discounted or free goods or services, possibly after further qualifying conditions are met.

IFRIC 13 stipulates the accounting by the entity that grants the award credits. It requires that such credits be separately identified as components of the sales transactions, thus reducing the profit recognized and resulting in the creation of a liability for the future goods or services to be provided to its customers. The liability thereby created is discharged when the subsequent free or discounted service is provided, or, if a third party is to provide the later goods or services, when the third party becomes obligated to provide such goods or services. If the customer forfeits its right (e.g., by expiration of a contractual period for redemption of the credits), revenue is to be recognized at that time.

This accounting requirement is, conceptually at least, straightforward. A key issue is the proper measurement to be applied to this obligation. IFRIC 13 resolves this by specifying that the *fair value* of the award credits is the proper measure. The interpretation stipulates that this is given by reference to the fair value of the goods or services that would be offered to customers who had not accumulated credits from the initial transactions. For example, if “frequent flier” mileage points are awarded, and if, say, 25,000 mileage points result in a free round-trip flight to any domestic destination, the service provider (airline) would use the average retail price of such tickets as a basis for accruing such obligations.

Where a third party assumes this responsibility, there would usually be a contractually agreed value, making recognition of the amount to be allocated to the program liability directly observable.

Since the amount to be allocated to the obligation to provide future discounted or free goods or services is determined by reference to the fair value of the goods or services, the amount allocated to this liability is a reduction in the revenue immediately recognized. It is not an expense (such as a selling expense), because that treatment would be consistent with measurement by reference to the reporting entity’s cost of providing the future goods or services. Put another way, the solution prescribed by IFRIC 13 is based on a revenue recognition approach, not a cost accrual approach, to financial reporting.

The only exception to the foregoing occurs when the expected cost of delivering the free or discounted goods or services is anticipated to exceed the revenue associated with that event. Consistent with practice under other IFRS, these anticipated losses must be accrued at the date the initial transactions occur.

As noted, experience suggests that some portion of the program points will be forfeited by customers (i.e., they will be earned but never redeemed). This can occur because some customers will fail to meet other qualifying conditions, such as by reaching some defined threshold such as number of miles needed to exercise the redemption, or because of the expiration of time. With experience, the reporting entity may develop the ability to accurately project the proportion of points awarded that will not be redeemed. IFRIC 13 provides that the accrual of the obligation is to be based on the fraction of points that will eventually be redeemed. This is an estimate and ultimately the facts will differ from the estimate, and as with other changes in accounting estimates, this is accounted for prospectively; it is not an error to be corrected by retroactive restatement.

For example, if customers earn one point for each €100 purchase, and need to accumulate 100 points to redeem them for a service having a fair value of €200, then the initial accounting need

is to recognize €2 of revenue reduction (and an equivalent liability creation) for each €100 transaction. If experience shows that 25% of such loyalty program points are ultimately forfeited, then the proper subsequent accounting would be to allocate only €1.50 of each €100 transaction already undertaken to this liability. If the estimate of the proportion to be forfeited is revised in later financial reporting periods, the liability for unredeemed points is adjusted in the later periods, thereby affecting profit recognized in those periods.

A final issue, not dealt with by IFRIC 13, is whether the allocation of the transaction amount should be apportioned between the initial transaction's revenue and the deferred revenue associated with the redemption of the loyalty points based on a pro rata assignment, or whether the deferred revenue should be the fair value of the future goods or services, with the residual being assigned to the initial transaction. Thus, both approaches would be acceptable—and, as usual, the reporting entity should consistently apply one or the other.

To illustrate this last matter, assume again that customers earn one point for each €100 purchase, and need to accumulate 100 points to redeem them for a service having a fair value of €200. Possible forfeitures are ignored in this example, for simplicity. The pro rata allocation method would assign  $[\text{€}100/(\text{€}100 + \text{€}2) = ] \text{€}98.04$  to the initial transaction, and would assign  $[\text{€}2/(\text{€}100 + \text{€}2) = ] \text{€}1.96$  to the obligation for future services, which will be recognized as revenue when the promised services are later performed. On the other hand, if the alternative method is used, the fair value of the future services, €2, is initially recorded, so the immediate transaction is reported as a €98 revenue event.

### ***Service concession arrangements***

In many countries, public-to-private service concession arrangements have evolved as a mechanism for providing public services. Under such arrangements, a private entity is used to construct, operate or maintain the infrastructure for public use such as roads, bridges, hospitals, airports, water distribution facilities and energy supply. IFRIC 12, *Service Concession Arrangements*, deals with a private sector entity (an operator) that provides a public service and operates and maintains that infrastructure (operation services) for a specified period of time. The Interpretation was published in late 2006, to be applied for financial years beginning on or after January 1, 2008. As a change in accounting policy, it was to be accounted for retrospectively, except if that proved to be impracticable.

This Interpretation applies to service concession arrangements when the infrastructure for public use is constructed or acquired by the operator or given for use by the grantor and (1) the grantor controls what services operator must provide, to whom and at what price, and (2) the grantor controls any significant residual interest in the existing infrastructure at the end of the term of the service concession arrangement. Because the grantor continues to control the infrastructure assets within the scope of the interpretation, these assets are not recognized as property, plant and equipment of the operator. The operator recognizes and measures revenue for the services it performs in accordance with IAS 11 or IAS 18. If more than one service is performed (e.g., construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable is allocated based on relative fair values of the services provided, when the amounts are separately identifiable. The nature of the consideration the operator receives in exchange for the construction services determines its subsequent accounting treatment.



When the consideration received is a financial asset because the operator has an unconditional contractual right to receive from the grantor cash or other financial asset (e.g., a loan or receivable, available-for-sale financial asset, or, if so designated upon initial recognition, a financial asset at fair value through profit or loss), the subsequent accounting in accordance with IAS 32 and IAS 39 would apply. In this case the grantor bears the risk (demand risk) that the cash flows generated from the users will not recover the operator's investment. A financial asset is recognized during construction, giving rise to revenues from construction recovered during the period of use of the asset.

An intangible asset is recognized when the consideration the operator receives consists of rights to charge users of the public service, for example a license to charge users tolls for using roads or bridges, and it is accounted for within the scope of IAS 38. In this case, the operator bears the risk (demand risk) that the cash flows generated from the use of the public service will not recover its investment. The intangible asset received from the grantor in exchange for the construction services is used to generate cash flows from users of the public service.

In situations where a service or an asset is obtained for no consideration from a party who has no investment interest in the entity, the terms and conditions around the asset given must be considered. Where no terms and conditions are imposed, revenue can be recognized immediately. Where terms and conditions are imposed, revenue can only be recognized as the terms and conditions set out are fulfilled.

In these situations, historical cost is not adequate to reflect properly the substance of the transaction, since the historical cost to the corporation would be zero. Accordingly, these events should be reflected at fair value. If long-lived assets are donated to the corporation, they should be recorded at their fair value at the date of donation, and the amount so recorded should be depreciated over the normal useful economic life of such assets. Disclosure will be required in the financial statements of both the assets donated and the conditions required to be met.

#### Example of donated capital

A board member of the for-profit organization Village Social Services donates land to the organization that has a fair market value of €1 million. Village Social Services records the donation with the following entry:

Land	1,000,000
Revenue—donations	1,000,000

The same board member donates one year of accounting labour to Village Social Services. The fair value of services rendered is €75,000. Village Social Services records the donation with the following entry:

Salaries—accounting department	75,000
Revenue—donations	75,000

The board member also donates one year of free rent of a local building to Village Social Services. The annual rent in similar facilities is €45,000. Village Social Services records the donation with the following entry:

Rent expense	45,000
Revenue—donations	45,000

Finally, the board member pays off a €100,000 debt owed by Village Social Services. Village Social Services records the donation with the following entry:

Notes payable	100,000
Revenue—donations	100,000

Following the closing of the fiscal period, the effect of all the foregoing donations will be reflected in Village Social Services' retained earnings account.

Note that IFRS explicitly addresses the proper accounting for government grants (see discussion in Chapter 21), which may differ from the foregoing illustrative example, which involved private donations only. Readers should be alert to further developments in this area.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES

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### Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX

#### Accounting policy: Revenue

Revenue comprises sales and services to external customers (excluding VAT and other sales taxes). IAS18 p35

Consideration received from customers is only recorded as revenue to the extent that the group has performed its contractual obligations in respect of that consideration. p89

Rental income from operating leases is recognized in income on a straight-line basis over the lease term. IAS17 p50

Interest revenue is recognized in the period in which interest is earned. The amount of revenue is measured using the effective interest rate method.

#### Note to financial statements: Revenue

	20XX	20XX-1	IAS18 p35
The group's revenue comprises:			
Sale of goods	X	X	
Property rental income	X	X	
Services rendered	X	X	
	<u>X</u>	<u>X</u>	

## CONSTRUCTION CONTRACT ACCOUNTING

### INTRODUCTION

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The principal concern of accounting for long-term construction contracts involves the timing of revenue (and thus profit) recognition. It has been well accepted that, given the long-term nature of such projects, deferring revenue recognition until completion would often result in the presentation of periodic financial reports that fail to meaningfully convey the

true level of activity of the reporting entity during the reporting period. In extreme cases in fact, there could be periods of no apparent activity, and others of exaggerated amounts, when the entity was operating at a rather constant rate of production during all of the periods. To avoid these distortions, the percentage-of-completion method was developed, which reports the revenues proportionally to the degree to which the projects are being completed, even in the absence of full completion and, in many cases, even in the absence of the right to collect for the work done to date.

The major challenges in using percentage-of-completion accounting are to accurately gauge the extent to which the projects are being finished, and to assess the ability of the entity to actually bill and collect for the work done. Since many projects are priced at fixed amounts, or in some other fashion prevent the passing through to the customers the full amount of cost overruns, the computation of periodic profits must be sensitive not merely to the extent to which the project is nearing completion, but also to the terms of the underlying contractual arrangements.

IAS 11 is the salient IFRS addressing the accounting for construction contracts and other situations in which the percentage-of-completion method of revenue recognition would be appropriate. This standard uses the recognition criteria established by the IASB's *Framework* as the basis for the guidance it offers on accounting for construction contracts. The various complexities in applying IAS 11, including the estimation of revenues, costs and progress toward completion, are set forth in the following discussion.

<p><b>Sources of IFRS</b></p>
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<p><i>IAS 11, 23, 37</i></p>
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## DEFINITIONS OF TERMS

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**Claims.** Amounts in excess of the agreed-on contract price that a contractor seeks to collect from a customer (or another party) for customer-caused delays, errors in specifications and designs, disputed variations in contract work, or other occurrences that are alleged to be the causes of unanticipated costs.

**Combining (grouping) contracts.** Grouping two or more contracts, whether with a single customer or with several customers, into a single profit center for accounting purposes, provided that:

1. The group of contracts is negotiated as a single package;
2. The contracts combined are so closely interrelated that, in essence, they could be considered as a single contract negotiated with an overall profit margin; and
3. The contracts combined are either executed concurrently or in a sequence.

**Construction contract.** Contract specifically entered into for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their end use or purpose.

**Construction-in-progress (CIP).** Inventory account used to accumulate the construction costs of the contract project. For the percentage-of-completion method, the CIP account also includes the gross profit earned to date.

**Contract costs.** Comprised of costs directly related to a specific contract, costs that are attributable to the contract activity in general and can be allocated to the contract, and other costs that are specifically chargeable to the customer under the terms of the contract.

**Contract revenue.** Comprised of initial amount of revenue stipulated by the contract plus any variations in contract work, claims and incentive payments, provided that these extra amounts of revenue meet the recognition criteria set by the IASB's *Framework* (i.e., regarding the probability of future economic benefits flowing to the contractor and reliability of measurement).

**Cost-plus contract.** Construction contract in which the contractor is reimbursed for allowable costs plus either a percentage of these costs or a fixed fee.

**Estimated cost to complete.** Anticipated additional cost of materials, labour, subcontracting costs and indirect costs (overhead) required to complete a project at a scheduled time.

**Fixed-price contract.** Construction contract wherein the contract revenue is fixed either in absolute terms or is fixed in terms of unit rate of output; in certain cases both fixed prices being subject to any cost escalation clauses, if allowed by the contract.

**Incentive payments.** Any additional amounts payable to the contractor if specified performance standards are either met or surpassed.

**Percentage-of-completion method.** Method of accounting that recognizes income on a contract as work progresses by matching contract revenue with contract costs incurred, based on the proportion of work completed. However, any expected loss, which is the excess of total incurred and expected contract costs over the total contract revenue, is recognized immediately, irrespective of the stage of completion of the contract.

**Segmenting contracts.** Dividing a single contract, which covers the construction of a number of assets, into two or more profit centers for accounting purposes, provided that:

1. Separate proposals were submitted for each of the assets that are the subject matter of the single contract.
2. The construction of each asset was the subject of separate negotiation wherein both the contractor and the customer were in a position to either accept or reject part of the contract pertaining to a single asset (out of numerous assets contemplated by the contract).
3. The costs and revenues pertaining to each individual asset can be separately identified.

**Stage of completion.** Proportion of the contract work completed, which may be determined using one of several methods that reliably measures it, including:

1. Percentage-of-completion method.
2. Surveys of work performed.
3. Physical proportion of contract work completed.

**Variation.** Instruction by the customer for a change in the scope of the work envisioned by the construction contract.

## RECOGNITION AND MEASUREMENT

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Construction contract revenue may be recognized during construction rather than at the completion of the contract. This "as earned" approach to revenue recognition is justified because under most long-term construction contracts, both the buyer and the seller (contractor) obtain enforceable rights. The buyer has the legal right to require specific performance from the contractor and, in effect, has an ownership claim to the contractor's work in progress. The contractor, under most long-term contracts, has the right to require the buyer to make progress payments during the construction period. The substance of this business activity is that a continuous sale occurs as the work progresses.

IAS 11 recognizes the percentage-of-completion method as the method of accounting for construction contracts (or the cost of recovery approach, when the outcome of a construction contract cannot be estimated reliably). Under an earlier version of IAS 11, both the percentage-of-completion method and the completed-contract method were recognized as being acceptable alternative methods of accounting for long-term construction activities. The completed-contract method of accounting is thus no longer permitted under circumstances where application of percentage-of-completion is warranted.

### **Percentage-of-Completion Method**

IAS 11 defines the percentage-of-completion method as follows:

*Under this method contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed . . . . Contract revenue is recognized as revenue in the statement of comprehensive income in the accounting periods in which the work is performed. Contract costs are usually recognized as an expense in the accounting periods in which the work to which they relate is performed. However, any expected excess of total revenue for the contract is recognized as an expense immediately.*

Under the percentage-of-completion method, the construction-in-progress (CIP) account is used to accumulate costs and recognized income. When the CIP exceeds billings, the difference is reported as a current asset. If billings exceed CIP, the difference is reported as a current liability. Where more than one contract exists, the excess cost or liability should be determined on a project-by-project basis, with the accumulated costs and liabilities being stated separately in the statement of financial position. Assets and liabilities should not be offset unless a right of offset exists. Thus, the net debit balances for certain contracts should not ordinarily be offset against net credit balances for other contracts.

Under the percentage-of-completion method, income should not be based on advances (cash collections) or progress (interim) billings. Cash collections and interim billings are based on contract terms that do not necessarily measure contract performance.

Costs and estimated earnings in excess of billings should be classified as an asset. If billings exceed costs and estimated earnings, the difference should be classified as a liability.

### ***Contract costs***

Contract costs comprise costs that are identifiable with a specific contract, plus those that are attributable to contracting activity in general and can be allocated to the contract and those that are contractually chargeable to a customer. Generally, contract costs would include all direct costs, such as direct materials, direct labour, and direct expenses and any construction overhead that could specifically be allocated to specific contracts.

Direct costs or costs that are identifiable with a specific contract include:

1. Costs of materials consumed in the specific construction contract.
2. Wages and other labour costs for site labour and site supervisors.
3. Depreciation charges of plant and equipment used in the contract.
4. Lease rentals of hired plant and equipment specifically for the contract.
5. Cost incurred in shifting of plant, equipment and materials to and from the construction site.
6. Cost of design and technical assistance directly identifiable with a specific contract.

7. Estimated costs of any work undertaken under a warranty or guarantee.
8. Claims from third parties.

With regard to claims from third parties, these should be accrued if they rise to the level of “provisions” as defined by IAS 37. This requires that an obligation that is subject to reasonable measurement exist at the end of the reporting period. However, if either of the above mentioned conditions is not met (and the possibility of the loss is not remote), this contingency will only be disclosed. Contingent losses are specifically required to be disclosed under IAS 11.

Contract costs may be reduced by incidental income if such income is not included in contract revenue. For instance, sale proceeds (net of any selling expenses) from the disposal of any surplus materials or from the sale of plant and equipment at the end of the contract may be credited or offset against these expenses. Drawing an analogy from this principle, it could be argued that if advances received from customers are invested by the contractor temporarily (instead of being allowed to lie idle in a current account), any interest earned on such investments could be treated as incidental income and used in reducing contract costs, which may or may not include borrowing costs (depending on how the contractor is financed, whether self-financed or leveraged). On the other hand, it may also be argued that instead of being subtracted from contract costs, such interest income should be added to contract revenue.

In the authors’ opinion, the latter argument may be valid if the contract is structured in such a manner that the contractor receives lump-sum advances at the beginning of the contract (or for that matter, even during the term of the contract, such that the advances at any point in time exceed the amounts due the contractor from the customer). In these cases, such interest income should, in fact, be treated as contract revenue and not offset against contract costs. The reasoning underlying treating this differently from the earlier instance (where idle funds resulting from advances are invested temporarily) is that such advances were envisioned by the terms of the contract and as such were probably fully considered in the negotiation process that preceded fixing contract revenue. Thus, since negotiated as part of the total contract price, this belongs in contract revenues. (It should be borne in mind that the different treatments for interest income would in fact have a bearing on the determination of the percentage or stage of completion of a construction contract.)

Indirect costs or overhead expenses should be included in contract costs provided that they are attributable to the contracting activity in general and could be allocated to specific contracts. Such costs include construction overhead, cost of insurance, cost of design and technical assistance that is not related directly to specific contracts. They should be allocated using methods that are systematic and rational and are applied in a consistent manner to costs having similar features or characteristics. The allocation should be based on the normal level of construction activity, not on theoretical maximum capacity.

#### **Example of contract costs**

A construction company incurs €700,000 in annual rental expense for the office space occupied by a group of engineers and architects and their support staff. The company utilizes this group to act as the quality assurance team that overlooks all contracts undertaken by the company. The company also incurs in the aggregate another €300,000 as the annual expenditure toward electricity, water and maintenance of this office space occupied by the group. Since the group is responsible for quality assurance for all contracts on hand, its work, by nature, cannot be considered as being directed toward any specific contract but is in support of the entire contracting

activity. Thus, the company should allocate the rent expense and the cost of utilities in accordance with a systematic and rational basis of allocation, which should be applied consistently to both types of expenditure (since they have similar characteristics).

Although the bases of allocation of this construction overhead could be many (such as the amounts of contract revenue, contract costs and labour hours utilized in each contract) the basis of allocation that seems most rational is contract revenue. Further, since both expenses are similar in nature, allocating both the costs on the basis of the amount of contract revenue generated by each construction contract would also satisfy the consistency criteria.

Other examples of construction overhead or costs that should be allocated to contract costs are:

1. Costs of preparing and processing payroll of employees engaged in construction activity.
2. Borrowing costs capitalized under IAS 23.

Certain costs are specifically excluded from allocation to the construction contract, as the standard considers them as not attributable to the construction activity. Such costs may include:

1. General and administrative costs that are not directly attributable to the contract.
2. Costs incurred in marketing or selling.
3. Research and development costs that are not directly attributable to the contract.
4. Depreciation of plant and equipment that is lying idle and not used in any particular contract.

### ***Types of contract costs***

Contract costs can be broken down into two categories: costs incurred to date and estimated costs to complete. The *costs incurred to date* include precontract costs and costs incurred after contract acceptance. *Precontract costs* are costs incurred before a contract has been entered into, with the expectation that the contract will be accepted and these costs will thereby be recoverable through billings. The criteria for recognition of such costs are:

1. They are capable of being identified separately.
2. They can be measured reliably.
3. It is probable that the contract will be obtained.

Precontract costs include costs of architectural designs, cost of securing the contract, and any other costs that are expected to be recovered if the contract is accepted. Contract costs incurred after the acceptance of the contract are costs incurred toward the completion of the project and are also capitalized in the construction-in-progress (CIP) account. The contract does not have to be identified before the capitalization decision is made; it is only necessary that there be an expectation of the recovery of the costs. Once the contract has been accepted, the precontract costs become contract costs incurred to date. However, if the precontract costs are already recognized as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

### ***Estimated costs to complete***

These are the anticipated costs required to complete a project. They would be comprised of the same elements as the original total estimated contract costs and would be based on

prices expected to be in effect when the costs are incurred. The latest estimates should be used to determine the progress toward completion.

Although IAS 11 does not specifically provide instructions for estimating costs to complete, practical guidance can be gleaned from other international accounting standards, as follows: The first rule is that systematic and consistent procedures should be used. These procedures should be correlated with the cost accounting system and should be able to provide a comparison between actual and estimated costs. Additionally, the determination of estimated total contract costs should identify the significant cost elements.

A second important point is that the estimation of the costs to complete should include the same elements of costs included in accumulated costs. Additionally, the estimated costs should reflect any expected price increases. These expected price increases should not be blanket provisions for all contract costs, but rather, specific provisions for each type of cost. Expected increases in each of the cost elements such as wages, materials and overhead items should be taken into consideration separately.

Finally, estimates of costs to complete should be reviewed periodically to reflect new information. Estimates of costs should be examined for price fluctuations and should also be reviewed for possible future problems, such as labour strikes or direct material delays.

Accounting for contract costs is similar to accounting for inventory. Costs necessary to ready the asset for sale would be recorded in the construction-in-progress account, as incurred. CIP would include both direct and indirect costs but would usually not include general and administrative expenses or selling expenses since they are not normally identifiable with a particular contract and should therefore be expensed.

### ***Subcontractor costs***

Since a contractor may not be able to do all facets of a construction project, a subcontractor may be engaged. The amount billed to the contractor for work done by the subcontractor should be included in contract costs. The amount billed is directly traceable to the project and would be included in the CIP account, similar to direct materials and direct labour.

### ***Back charges***

Contract costs may have to be adjusted for back charges. Back charges are billings for costs incurred that the contract stipulated should have been performed by another party. The parties involved often dispute these charges.

#### **Example of a back charge situation**

The contract states that the subcontractor was to raze the building and have the land ready for construction; however, the contractor/seller had to clear away debris in order to begin construction. The contractor wants to be reimbursed for the work; therefore, the contractor back charges the subcontractor for the cost of the debris removal.

The contractor should treat the back charge as a receivable from the subcontractor and should reduce contract costs by the amount recoverable. If the subcontractor disputes the back charge, the cost becomes a claim. Claims are an amount in excess of the agreed contract price or amounts not included in the original contract price that the contractor seeks to collect. Claims should be recorded as additional contract revenue only if the requirements set forth in IAS 11 are met.



The subcontractor should record the back charge as a payable and as additional contract costs if it is probable that the amount will be paid. If the amount or validity of the liability is disputed, the subcontractor would have to consider the probable outcome in order to determine the proper accounting treatment.

### Fixed-Price and Cost-Plus Contracts

IAS 11 recognizes two types of construction contracts that are distinguished based on their pricing arrangements: (1) fixed-price contracts, and (2) cost-plus contracts.

**Fixed-price contracts** are contracts for which the price is not usually subject to adjustment because of costs incurred by the contractor. The contractor agrees to a fixed contract price or a fixed rate per unit of output. These amounts are sometimes subject to escalation clauses.

There are two types of cost-plus contracts:

1. **Cost-without-fee contract**—Contractor is reimbursed for allowable or otherwise defined costs with no provision for a fee. However, a percentage is added that is based on the foregoing costs.
2. **Cost-plus-fixed-fee contract**—Contractor is reimbursed for costs plus a provision for a fee. The contract price on a cost-type contract is determined by the sum of the reimbursable expenditures and a fee. The fee is the profit margin (revenue less direct expenses) to be earned on the contract. All reimbursable expenditures should be included in the accumulated contract costs account.

There are a number of possible variations of contracts that are based on a cost-plus-fee arrangement. These could include cost-plus-fixed-fee, under which the fee is a fixed monetary amount; cost-plus-award, under which an incentive payment is provided to the contractor, typically based on the project's timely or on-budget completion; and cost-plus-a-percentage-fee, under which a variable bonus payment will be added to the contractor's ultimate payment based on stated criteria.

Some contracts may have features of both a fixed-price contract and a cost-plus contract. A cost-plus contract with an agreed maximum price is an example of such a contract.

### Recognition of Contract Revenue and Expenses

Percentage-of-completion accounting cannot be employed if the quality of information will not support a reasonable level of accuracy in the financial reporting process. Generally, only when the outcome of a construction contract can be estimated reliably, should the contract revenue and contract costs be recognized by reference to the stage of completion at the end of the reporting period.

Different criteria have been prescribed by the standard for assessing whether the outcome can be estimated reliably for a contract, depending on whether it is a fixed-price contract or a cost-plus contract. The following are the criteria in each case:

1. If it is a fixed-price contract:

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*NOTE: All conditions should be satisfied.*

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- a. It meets the recognition criteria set by the IASB's *Framework*; that is:

1. Total contract revenue can be measured reliably.

2. It is probable that economic benefits will flow to the entity.
  - b. Both the contract cost to complete and the stage of completion can be measured reliably.
  - c. Contract costs attributable to the contract can be identified properly and measured reliably so that comparison of actual contract costs with estimates can be done.
2. If it is a cost-plus contract,

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*NOTE: All conditions should be satisfied.*

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- a. It is probable that the economic benefits will flow to the entity.
- b. The contract costs attributable to the contract, whether or not reimbursable, can be identified and measured reliably.

### **When Outcome of a Contract Cannot Be Estimated Reliably**

As stated above, unless the outcome of a contract can be estimated reliably, contract revenue and costs should not be recognized by reference to the stage of completion. IAS 11 establishes the following rules for revenue recognition in cases where the outcome of a contract cannot be estimated reliably:

1. Revenue should be recognized only to the extent of the contract costs incurred that are probable of being recoverable.
2. Contract costs should be recognized as an expense in the period in which they are incurred.

Any expected losses should, however, be recognized immediately.

It is not unusual that during the early stages of a contract, the outcome cannot be estimated reliably. This would be particularly likely to be true if the contract represents a type of project with which the contractor has had limited experience in the past.

### **Contract Costs Not Recoverable Due to Uncertainties**

When recoverability of contract costs is considered doubtful, the cost recovery method is applied and revenue is recognized only to the extent of cash collections, after all costs have first been recovered through cash collections. Recoverability of contract costs may be considered doubtful in the case of contracts that have any of the following characteristics:

1. The contract is not fully enforceable.
2. Completion of the contract is dependent on the outcome of pending litigation or legislation.
3. The contract relates to properties that are likely to be expropriated or condemned.
4. The contract is with a customer who is unable to perform its obligations, perhaps because of financial difficulties.
5. The contractor is unable to complete the contract or otherwise meet its obligation under the terms of the contract, as when, for example, the contractor has been experiencing recurring losses and is unable to get financial support from creditors and bankers and may be ready to declare bankruptcy.

In all such cases, contract costs should be expensed immediately. Although the implication is unambiguous, the determination that one or more of the foregoing conditions

holds will be subject to some imprecision. Thus, each such situation needs to be assessed carefully on a case-by-case basis.

If and when these uncertainties are resolved, revenue and expenses should again be recognized on the same basis as other construction-type contracts (i.e., by the percentage-of-completion method). However, it is not permitted to restore costs already expensed in prior periods, since the accounting was not in error, given the facts that existed at the time the earlier financial statements were prepared.

### **Revenue Measurement—Determining the Stage of Completion**

The standard recognizes that the stage of completion of a contract may be determined in many ways and that an entity uses the method that measures reliably the work performed. The standard further stipulates that depending on the nature of the contract, one of the following methods may be chosen:

1. The proportion that contract costs incurred bear to estimated total contract cost (also referred to as the cost-to-cost method).
2. Survey of work performed method.
3. Completion of a physical proportion of contract work (also called units-of-work-performed) method.

*NOTE: Progress payments and advances received from customers often do not reflect the work performed.*

Each of these methods of measuring progress on a contract can be identified as being either an input or an output measure. The *input measures* attempt to identify progress in a contract in terms of the efforts devoted to it. The cost-to-cost method is an example of an input measure. Under the cost-to-cost method, the percentage of completion would be estimated by comparing total costs incurred to date to total costs expected for the entire job. *Output measures* are made in terms of results by attempting to identify progress toward completion by physical measures. The units-of-work-performed method is an example of an output measure. Under this method, an estimate of completion is made in terms of achievements to date. Output measures are usually not considered to be as reliable as input measures.

When the stage of completion is determined by reference to the contract costs incurred to date, the standard specifically refers to certain costs that are to be excluded from contract costs. Examples of such costs are:

1. Contract costs that relate to future activity (e.g., construction materials supplied to the site but not yet consumed during construction).
2. Payments made in advance to subcontractors prior to performance of the work by the subcontractor.

#### **Example of the percentage-of-completion method**

The percentage-of-completion method works under the principle that “recognized profit (should) be that percentage of estimated total profit . . . that incurred costs to date bear to estimated total costs.” The cost-to-cost method has become one of the most popular measures used to determine the extent of progress toward completion.

Under the cost-to-cost method, the percentage of revenue to recognize can be determined by the following formula:

$$\frac{\text{Cost to date}}{\text{Cumulative costs incurred} + \text{Estimated costs to complete}} \times \text{Contract price} \\ - \text{Revenue previously recognized} \\ = \text{Current revenue recognized}$$

By slightly modifying this formula, current gross profit can also be determined.

$$\frac{\text{Cost to date}}{\text{Cumulative costs incurred} + \text{Estimated costs to complete}} \times \text{Expected total gross profit} \\ - \text{Gross profit previously recognized} \\ = \text{Current gross profit}$$

#### Example of the percentage-of-completion (cost-to-cost)

Assume a €500,000 contract that requires three years to complete and incurs a total cost of €405,000. The following data pertain to the construction period:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Cumulative costs incurred to date	€150,000	€360,000	€405,000
Estimated costs yet to be incurred at year-end	300,000	40,000	--
Progress billings made during year	100,000	370,000	30,000
Collections of billings	75,000	300,000	125,000

	<u>Year 2</u>	<u>Year 2</u>	<u>Year 3</u>
Construction in progress	150,000	210,000	45,000
Cash, payables, etc.	150,000	210,000	45,000
Contract receivables	100,000	370,000	30,000
Billings on contracts	100,000	370,000	30,000
Cash	75,000	300,000	125,000
Contract receivables	75,000	300,000	125,000
Construction in progress	16,667	73,333	5,000
Cost of revenues earned	150,000	210,000	45,000
Contract revenues earned	166,667	283,333	50,000
Billings on contracts			500,000
Construction in progress			500,000

#### Statement of Comprehensive Income Presentation

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Total</u>
Contract revenues earned	€166,667*	€283,333**	€50,000***	€500,000
Cost of revenues earned	<u>(150,000)</u>	<u>(210,000)</u>	<u>(45,000)</u>	<u>(405,000)</u>
Gross profit	€ <u>16,667</u>	€ <u>73,333</u>	€ <u>5,000</u>	€ <u>95,000</u>

$$* \frac{€150,000}{450,000} \times 500,000 = €166,667$$

$$** \frac{€360,000}{400,000} \times 500,000 - 166,667 = €283,333$$

$$*** \frac{€405,000}{405,000} \times 500,000 - 166,667 - 283,333 = €50,000$$

<u>Statement of Financial Position Presentation</u>				
		<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
<i>Current assets:</i>				
Contract receivables		€25,000	€95,000	*
Costs and estimated earnings in excess of billings on uncompleted contracts	166,667**			
Construction in progress				
Less billings on long-term contracts	(100,000)	66,667		
Billings in excess of costs and estimated earnings on uncompleted contracts, year 2 (€470,000*** – €450,000****)			20,000	

\* Since the contract was completed and title was transferred in Year 3, there are no amounts reported in the statement of financial position. However, if the project is complete but transfer of title has not taken place, there would be a presentation in the statement of financial position at the end of the third year because the entry closing out the Construction-in-progress account and the Billings account would not have been made yet.

\*\* €150,000 (Costs) + 16,667 (Gross profit)

\*\*\* €100,000 (Year 1 Billings) + 370,000 (Year 2 Billings)

\*\*\*\* €360,000 (Costs) + 16,667 (Gross profit) + 73,333 (Gross profit)

**Recognition of Expected Contract Losses**

When the current estimate of total contract cost exceeds the current estimate of total contract revenue, a provision for the entire loss on the entire contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method. In other words, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately. The loss provision should be computed on the basis of the total estimated costs to complete the contract, which would include the contract costs incurred to date plus estimated costs (use the same elements as contract costs incurred) to complete. The provision should be shown separately as a current liability in the statement of financial position.

In any year when a percentage-of-completion contract has an expected loss, the amount of the loss reported in that year can be computed as follows:

$$\text{Reported loss} = \text{Total expected loss} + \text{All profit previously recognized}$$

**Example of the percentage-of-completion and completed-contract methods with loss contract**

Using the previous information, if the costs yet to be incurred at the end of Year 2 were €148,000, the total expected loss is €8,000 [= €500,000 – (360,000 + 148,000)], and the total loss reported in Year 2 would be €24,667 (= €8,000 + 16,667). Under the completed-contract method, the loss recognized is simply the total expected loss, €8,000.

	<u>Journal entry at end of Year 2</u>	<u>Percentage-of- Completion</u>
Loss on uncompleted long-term contract	24,667	
Construction in progress (or estimated loss on uncompleted contact)		24,667

<b>Profit or Loss Recognized on Contract</b>			
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Contract price	€500,000	€500,000	€500,000
Estimated total costs:			
Costs incurred to date	150,000	360,000	506,000*
Estimated cost yet to be incurred	300,000	148,000	--
Estimated total costs for the three-year period, actual for Year 3	<u>450,000</u>	<u>508,000</u>	<u>506,000</u>
Estimated profit (loss), actual for Year 3	16,667	(8,000)	(6,000)
Less profit (loss) previously recognized	--	16,667	(8,000)
Amount of estimated profit (loss) recognized in the current period, actual for Year 3	<u>€16,667</u>	<u>€(24,667)</u>	<u>€2,000</u>

\* Assumed

Upon completion of the project during Year 3, it can be seen that the actual loss was only €6,000 (= €500,000 – 506,000); therefore, the estimated loss provision was overstated by €2,000. However, since this is a change of an estimate, the €2,000 difference must be handled prospectively; consequently, €2,000 of profit should be recognized in Year 3 (= €8,000 previously recognized – €6,000 actual loss).

### Combining and Segmenting Contracts

The profit center for accounting purposes is usually a single contract, but under some circumstances the profit center may be a combination of two or more contracts, a segment of a contract, or a group of combined contracts. Conformity with explicit criteria set forth in IAS 11 is necessary to combine separate contracts, or segment a single contract; otherwise, each individual contract is presumed to be the profit center.

For accounting purposes, a group of contracts may be combined if they are so closely related that they are, in substance, parts of a single project with an overall profit margin. A group of contracts, whether with a single customer or with several customers, should be combined and treated as a single contract if the group of contracts:

1. Are negotiated as a single package.
2. Require such closely interrelated construction activities that they are, in effect, part of a single project with an overall profit margin.
3. Are performed concurrently or in a continuous sequence.

Segmenting a contract is a process of breaking up a larger unit into smaller units for accounting purposes. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue. According to IAS 11, a contract may cover a number of assets. The construction of each asset should be treated as a separate construction contract when:

1. The contractor has submitted separate proposals on the separate components of the project.
2. Each asset has been subject to separate negotiation and the contractor and customer had the right to accept or reject part of the proposal relating to a single asset.
3. The cost and revenues of each asset can be separately identified.

### **Contractual Stipulation for Additional Asset—Separate Contract**

The contractual stipulation for an additional asset is a special provision in the international accounting standard. IAS 11 provides that a contract may stipulate the construction of an additional asset at the option of the customer, or the contract may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract if:

1. The additional asset significantly differs (in design, technology or function) from the asset or assets covered by the original contract.
2. The price for the additional asset is negotiated without regard to the original contract price.

### **Changes in Estimate**

Since the percentage-of-completion method uses current estimates of contract revenue and expenses, it is normal to encounter changes in estimates of contract revenue and costs frequently. Such changes in estimate of the contract's outcome are treated on a par with changes in accounting estimate as defined by IAS 8 and are therefore accounted for prospectively in the year of the change.

### **Agreements for the Construction of Real Estate**

In June 2008, the IASB issued IFRIC 15, which deals with agreements for the construction of real estate. IFRIC 15 standardizes accounting practice across jurisdictions for the recognition of revenue by real estate developers for sales of units, such as apartments or houses before construction is complete.

The first issue the IFRIC addressed is whether the contract should be accounted for under IAS 11 or IAS 18. IFRIC 15 states that an agreement for the construction of real estate is a construction contract within the scope of IAS 11 only when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not). If the buyer has that ability, then the developer should apply IAS 11 to the contract. If the buyer does not have that ability, IAS 18 should be applied.

The main impact of this interpretation is that if the developer is required to apply IAS 11, then the percentage-of-completion basis should be applied. However, if they are required to apply IAS 18, then they first need to determine whether they are selling goods or providing a service. If the developer is not providing materials for a contract, but is only delivering services for the construction project, then they may apply the rendering of services method under IAS 18. If however they are required to provide all the materials and in addition deliver the services for the construction, then they will have to apply the sale of goods criteria in IAS 18. This can be problematic for developers as under this method, revenue is only recognized when the risks and rewards of ownership pass—which is generally on completion of the construction process.

IFRIC 15 also introduces a new concept in that it concludes that in certain circumstances, a developer may meet the IAS 18 sale of goods criteria continuously, thereby transferring the construction in progress to the customer throughout the contract. However, to achieve this, IFRIC 15 states that ownership of the construction in progress should pass to the client in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall

recognize revenue by reference to the stage of completion using the percentage-of-completion method.

## DISCLOSURE

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IAS 11 prescribes a number of disclosures; some of them are for all the contracts and others are only for contracts in progress at the end of the reporting period. These are summarized below.

1. Disclosures relating to all contracts:
  - a. Aggregate amount of contract revenue recognized in the period.
  - b. Methods used in determination of contract revenue recognized in the period.
2. Disclosures relating to contracts in progress:
  - a. Methods used in determination of stage of completion (of contracts in progress).
  - b. Aggregate amount of costs incurred and recognized profits (net of recognized losses) to date.
  - c. Amounts of advances received (at the end of the reporting period).
  - d. Amount of retentions (at the end of the reporting period).

### Financial Statement Presentation Requirements under IAS 11

Gross amounts due from customers should be reported as an asset. This amount is the net of:

1. Costs incurred plus recognized profits; less
2. The aggregate of recognized losses and progress billings.

This represents, in the case of contracts in progress, excess of contract costs incurred plus recognized profits, net of recognized losses, over progress billings.

Gross amounts due to customers should be reported as a liability. This amount is the net of:

1. Costs incurred plus recognized profits; less
2. The aggregate of the recognized losses and progress billings.

This represents, in the case of contract work in progress, excess of progress billings over contract costs incurred plus recognized profits, net of recognized losses.

## FUTURE DEVELOPMENTS

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In May 2014 the IASB issued IFRS 15, *Revenue Recognition from Contracts with Customers*, which provides a single revenue recognition model that can be applied consistently across various industries, geographical regions and transactions. IFRS 15 is effective January 1, 2017 and there is a strong possibility that the effective date will be extended to January 1, 2018. The core principle in the standard is that an entity should recognize revenues in contracts to provide goods and services to customers when it satisfies its performance obligations under the contract by transferring goods or services to a customer.



The key principles that are addressed include:

- *Revenue is recognized only from the transfer of goods or services to a customer*—This will affect some long-term contracts currently accounted for using a percentage-of-completion method when the customer does not receive goods or services continuously (for example where construction projects and service provision contracts are being undertaken that do not result in the transfer of the product or service until it is complete). An entity would be permitted to apply the percentage-of-completion method of revenue recognition if it transfers the services rendered to the customer throughout the contract. As such, the customer would need to take ownership of the work in progress as the contract is performed, should the entity wish to recognize revenue on an ongoing basis.
- *Identification of separate performance obligations for distinct goods or services*—Where a contract that is undertaken is made up of various components, the entity delivering on the contract is required to account for all goods or services that can be identified as separate performance obligations. This may result in some revenue being attributed to goods or services that may presently be considered as incidental to the contract being undertaken and might otherwise not have hitherto been accounted for. This could also result in an entity identifying more performance obligations in contracts, especially on construction contracts, as compared with present practice. As a result, such accounting treatment could result in entities reporting different margins for different parts of the contract, rather than reporting a single margin for the entire contract.
- *Recognition of revenue based on the probability-weighted estimates of the consideration expected to be received*—An entity is required to include reasonable estimates of contingent consideration in the transaction price allocated to performance obligations. This is a significant departure from current practice, and it could result in a company recognizing some revenue on the transfer of a good or service, even if the consideration amount is contingent upon the occurrence of a future event—for example, an agent that provides brokerage services in one period in exchange for an amount of consideration to be determined in future periods, depending on the customer's behaviour.
- *Customer's credit risk reflected in the measurement of revenue*—When determining the amount of revenue to recognize, an entity is required to take into account the possibility that some of the consideration may not be recoverable from the customer. This differs to some extent from the current practice, which requires there to be some certainty around the collectibility of the amount due before revenue can be recognized, in that this proposal could result in a company recognizing some revenue when it transfers a good or service to a customer even if there is uncertainty about the collectibility of the consideration, rather than deferring revenue recognition until the consideration is collected.
- *Allocation of transaction price in proportion to the estimated stand-alone selling price*—If an entity does not sell a distinct good or service separately, it would be required to estimate the price at which it would sell that good or service in order to allocate some of the consideration to it. This will affect some existing practices that currently result in the deferral of revenue if an entity does not have objective evidence of the selling price of a good or service to be provided.

- *Expensing of contract acquisition costs*—An entity is required to recognize as an expense the costs of obtaining a contract, other than costs that are incremental on obtaining the contract. This would affect companies that currently capitalize such costs—for example, legal fees that would be incurred whether the contract is obtained or not—and amortize them over the contract period.

The new proposed revenue recognition model will also be applicable to construction contracts.

## US GAAP COMPARISON

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US GAAP guidance for revenue recognition is composed of over 100 pieces of literature from the FASB and US Securities and Exchange Commission. US revenue guidance is very prescriptive. However, the core principles of revenue recognition for US GAAP are similar to IFRS. Revenue must be realized or realizable and earned. A valid agreement with a customer must be in place that establishes the terms of the exchange, performance must have occurred, the risks and rewards of ownership must have passed, and collectability must be reasonably assured. Public companies must follow the guidance in the SEC's SAB Topic 13, *Revenue Recognition*: Persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectability is reasonably assured. Despite this similarity, US GAAP contains many exceptions to these principles that have the effect of deferring revenue that is otherwise earned. Also, US GAAP provides separate definitions of revenue and gains.

US GAAP measures revenue based on the fair value of what is given up or the fair value of what is received, whichever is more evident. On the other hand IFRS measures revenue based on the fair value of what is received or receivable. US GAAP includes specialized accounting for multiple-deliverable arrangements which, in principle, are the same as IFRS but include clauses that delay recognition until reliability of measurement complies with a concept called Vendor-Specific Objective Evidence (VSOE). VSOE can be either the price charged for a deliverable when sold separately or the price established by management having the relevant authority, where it is probable that the price will not change before the separate introduction of the deliverable into the marketplace. The US Securities and Exchange Commission provides even more detailed guidelines for registered entities. In summary, if VSOE is not available for any of the elements, the full revenue of the arrangement cannot be recognized.

Another departure from the core principles is called the Milestone Method. This method, used mainly for research and development arrangements, delays revenue recognition based on satisfying conditions agreed at the inception of the agreement. These milestones cannot be changed once work has begun. Additionally, entities are permitted to delay revenue recognition further, based on an accounting policy decision.

US GAAP includes extensive guidance for recognition and presentation of customer incentive payments, which are largely within the IFRS Framework, with some exceptions for measuring "breakage" or non-use of incentives by customers.

US GAAP literature for revenue recognition for construction and production-type contracts contains much more guidance than IFRS. Separation and combination of contracts is different in some instances. The language in US GAAP for construction and production-type contracts is written in terms of options rather than prescription. However, in

practice, the guidance is treated as mandatory. If certain criteria are met, the percentage-of-completion method is used in US GAAP. If not, the completed contract method is used.

Other detailed US GAAP guidance is required for specific industries including: airlines, financial services, oil and gas, real estate, healthcare, entertainment, development stage and non-profit.

In 2014, the FASB and IASB issued a joint revenue recognition standard. In US GAAP, this standard was established as Accounting Standards Codification section 606—*Revenue from Contracts with Customers*, which is nearly identical to IFRS 15 except for some transitional matters and matters that are consequences of the inherent differences between IFRS and US GAAP. For a public entity, ASC 606 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is not permitted.

As originally issued, IAS 20 held that below-market interest on government loans was not government assistance, per se. As part of the *2007 Improvements Project*, the IASB issued in early 2008 an amendment to IAS 20 (effective 2009), under which the economic effect of below-market interest rates on government loans is to be measured and reported as a government grant. The economic effect is gauged by the difference between the face amount of the loan and the present value of the future payments discounted by a relevant (market) interest rate, as illustrated later in this chapter.

A former gap in the literature, addressing the accounting for service concessions, which occur relatively frequently in Europe, where government assets may be operated by commercial entities, has recently been dealt with by the issuance of IFRIC 12, *Service Concession Arrangements*, which resolved a related series of three draft interpretations. IFRIC 12 is discussed later in this chapter.

Until it is revised, however, IAS 20 provides the authoritative guidance on financial statement presentation for all entities enjoying government grants or assistance, with additional guidance to be found within IAS 41, *Agriculture*, which is, however, at this time restricted to agricultural situations. IAS 20 deals with the accounting treatment and disclosure of government grants and the disclosure requirements of government assistance. Depending on the nature of the assistance given and the associated conditions, government assistance could be of many types, including grants, forgivable loans, and indirect or non-monetary forms of assistance, such as technical advice.

<i>IAS 20, 41</i>	<b>Sources of IFRS</b>	<i>SIC 10, 29, IFRIC 12</i>
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## SCOPE

IAS 20 deals with the accounting treatment and disclosure requirements of grants received by entities from a government. It also mandates disclosure requirements of other forms of government assistance.

The standard specifies certain exclusions. In addition to the four exclusions contained within the definitions of the terms “government grant” and “government assistance,” IAS 20 *excludes* the following from the scope of the standard:

1. Special problems arising in reflecting the effects of changing prices on financial statements or similar supplementary information;
2. Government assistance provided in the form of tax benefits (including income tax holidays, investment tax credits, accelerated depreciation allowances and concessions in tax rates);
3. Government participation in the ownership of the entity; and
4. Government grants covered by IAS 41.

The rationale behind excluding items 1. and 2. above seems fairly obvious, as they are covered by other IASs; IAS 29, *Financial Reporting in Hyperinflationary Economies* addresses accounting in hyperinflationary conditions, while tax benefits are dealt with by IAS 12, *Income Taxes*. Government participation in the ownership of the entity has been excluded from the scope of IAS 20, as participation in ownership of an enterprise is normally made in anticipation of a return on the investment, while government assistance is provided

with a different economic objective in mind, for example, the public interest or public policy. Thus, when the government invests in the equity of an entity (with the intention, for example, of encouraging the entity to undertake a line of business that it would normally not have embarked upon), such government participation in ownership of the entity would *not qualify* as a government grant under this standard.

### Government Grants

Government grants are assistance provided by government through means of a transfer of resources (either monetary or non-monetary), to business or other types of entities. In order to qualify as a government grant, in strict technical terms, it is a prerequisite the grant should be provided by the government to an entity in return for past or future compliance with conditions relating to the operating activities of the entity.

Prior to the issuance of SIC 10, *Government Assistance—No Specific Relation to Operating Entities*, it was unclear whether the provisions of IAS 20 would apply even to government assistance aimed at encouraging or supporting business activities in certain regions or industry sectors, since related conditions may not specifically relate to the operating activities of the entity. Examples of such grants are: government grants which involve transfer of resources to enterprises to operate in a particular area (e.g., an economically less developed area) or a particular industry (e.g., one that due to low profitability may not otherwise be attractive to entrepreneurs). SIC 10 clarified that “the general requirement to operate in certain regions or industry sectors in order to qualify for the government assistance constitutes such a condition in accordance with IAS 20.” This confirms that such government assistance does fall within the definition of government grants, and thus the requirements of IAS 20 apply to them as well.

## DEFINITIONS OF TERMS

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**Forgivable loans.** Those loans which the lender undertakes to waive repayment of under certain prescribed conditions.

**Government.** For the purposes of IAS 20, the term government refers not only to a government (of a country), as is generally understood, but also to government agencies and similar bodies, whether local, national or international.

**Government assistance.** Government assistance is action taken by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

**Government grants.** A government grant is a form of a government assistance that involves the transfer of resources to an entity in return for past or future compliance (by the entity) with certain conditions relating to its operating activities. It excludes:

- Those forms of government assistance that cannot reasonably be valued; and
- Transactions with governments that cannot be distinguished from the normal trading transactions of the enterprise.

**Grants related to assets.** Those government grants whose primary condition is that an entity qualifying for them should acquire (either purchase or construct) a long-term asset or

assets are referred to as “grants related to assets.” Secondary conditions may also be attached to such a grant. Examples of secondary conditions include specifying the type of long-term assets, location of long-term assets, or periods during which the long-term assets are to be acquired or held.

**Grants related to income.** Government grants, other than those related to assets, are grants related to income.

## RECOGNITION OF GOVERNMENT GRANTS

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### *Criteria for recognition*

Government grants are provided in return for past or future compliance with certain defined conditions. Thus grants should not be recognized until there is *reasonable assurance* that both:

1. The entity will comply with the conditions attaching to the grant; and
2. The grant(s) will be received.

Certain concerns affecting the application of IAS 20, relating to recognition and treatment of government grants, are addressed in the following paragraphs.

Firstly, the mere receipt of the grant does not provide any assurance that, in fact, the conditions attaching to the grant have been or will be complied with by the enterprise. Both of these conditions are equally important, and the reporting entity should have reasonable assurance with respect to these two conditions before a grant is to be recognized.

Secondly, the term “reasonable assurance” has not been defined by this standard. However, one of the recognition criteria for income under the IASB’s *Framework* is the existence of a “sufficient degree of certainty.”

Thirdly, under IAS 20 a forgivable loan from a government is treated as a government grant when there is *reasonable assurance* that the enterprise will meet the terms of forgiveness set forth in the loan agreement. Thus, upon receiving a forgivable loan from a government and furthermore upon fulfilling the criterion of reasonable assurance with respect to meeting the terms of forgiveness of the loan, an enterprise would normally recognize the receipt of a government grant, rather than a loan. Some have suggested that the grant should be recognized when the loan is forgiven, not when the forgivable loan is received. Under IAS 20, however, it is quite apparent that delayed recognition is not prescribed, but that “a forgivable loan from the government is treated as a grant when there is reasonable assurance that the enterprise will meet the terms for forgiveness of the loan.” In the authors’ opinion, this unambiguously directs that the recognition of the grant is to be made at the point of time when the forgivable loan is granted, as opposed to the point of time when it is actually forgiven.

Once a grant has been recognized, IAS 20 clarifies that any related contingency would be accounted for in accordance with IAS 37.

Fourthly, a conflict between IAS 20 and IAS 39 has been resolved by the issuance of an amendment to IAS 20 effected by the *2007 Improvements Project*. Previously, IAS 20 did not take account of low-interest or interest-free loans, or of the effect of government guarantees, while IAS 39 states that liabilities should be measured at fair value, which implies recognition of market rates of interest. The IAS 20 exclusion has now been removed, and the principle set forth by IAS 39 became applicable beginning in 2009.

**Example of application of amendment to IAS 20 for below-market loans**

Maytag Corp. is encouraged to relocate to Springville Township on July 1, 20XX, by an economic stimulus package that includes a €3,000,000 loan due in equal annual instalments (inclusive of interest) through 2025. The local government provides this loan at a below-market rate of 3%, which differs markedly from Maytag's own marginal borrowing rate of 6.5%. The present value of the annual payments (\$351,000 each), discounted at 6.5%, is only \$2,528,251. Accordingly, the receipt of the loan on July 1, 20XX, is recorded by the following journal entry:

Cash		3,000,000	
	Loan payable		2,528,251
	Income—government grants		471,749

The discount on the loan payable is amortized over the 10-year term, such that an effective rate of 6.5% on the loan balance will be reported as interest expense in Maytag's income statements. If the grant was unconditional, it would be taken into income immediately, as suggested by the above journal entry. However, if Maytag has ongoing obligations (such as to remain as an employer in the community throughout the term of the loan), then it should be amortized to income (on a straight-line basis) over the term of the obligation.

**Recognition period**

There are two broad approaches to the accounting treatment of government grants that have been discussed by the standard: the “capital approach” and the “income approach.” IAS 20 does *not* support the capital approach, which advocates crediting a grant directly to shareholders' equity. Endorsing the income approach, the standard sets forth the rule for recognition of government grants as follows: Government grants should be recognized as income, on a systematic and rational basis, over the periods necessary to match them with the related costs. As a corollary, and by way of abundant precaution, the standard reiterates that government grants should *not* be credited directly to shareholders' interests.

The standard established rules for recognition of grants under different conditions. These are explained through numerical examples below:

1. Grants in recognition of specific costs are recognized as income over the same period as the relevant expense.

**Example of a grant received in recognition of specific costs**

An enterprise receives a grant of €30 million to defray environmental costs over a period of five years. Environmental costs will be incurred by the enterprise as follows:

<u>Year</u>	<u>Costs</u>
1	€1 million
2	€2 million
3	€3 million
4	€4 million
5	€5 million

Total environment costs will equal €15 million, whereas the grant received is €30 million.

Applying the principle outlined in the standard for recognition of the grant, that is, recognizing the grant as income “over the period which matches the costs” and using a

“systematic and rational basis” (in this case, a reverse sum-of-the-years’ digits amortization), the total grant would be recognized as follows:

<u>Year</u>	<u>Grant recognized</u>
1	$€30 * (1/15) = €2$ million
2	$€30 * (2/15) = €4$ million
3	$€30 * (3/15) = €6$ million
4	$€30 * (4/15) = €8$ million
5	$€30 * (5/15) = €10$ million

- Grants related to depreciable assets are usually recognized as income over the periods and in the proportions in which depreciation on those assets is charged.

#### Example of a grant relating to a depreciable asset

An enterprise receives a grant of €100 million to purchase a refinery in an economically disadvantaged area. The enterprise has estimated that such a refinery would cost €200 million. The secondary condition attached to the grant is that the enterprise should hire labour locally (i.e., from the economically disadvantaged area where the refinery is located) instead of employing workers from other parts of the country. It should maintain a ratio of 1:1 (local workers: workers from outside) in its labour force for the next five years. The refinery is to be depreciated using the straight-line method over a period of 10 years.

The grant will be recognized over a period of 10 years. In each of the 10 years, the grant will be recognized in proportion to the annual depreciation on the refinery. Thus, €10 million will be recognized as income in each of the 10 years. With regard to the secondary condition of maintenance of the ratio of 1:1 in the labour force, as there is a possibility that some of the loan may need to be repaid, this contingency would need to be disclosed in the notes to the financial statements for the next five years (during which period the condition is in force) in accordance with disclosure requirements of IAS 37.

- Grants related to non-depreciable assets may also require the fulfillment of certain obligations and would then be recognized as income over periods which bear the cost of meeting the obligations.

#### Example of a grant with conditions attached relating to a non-depreciable asset

ABN Inc. was granted 1000 acres of land, on the outskirts of the city, by a local government authority. The condition attached to this grant was that ABN Inc. should clean up this land and lay roads by employing labourers from the village in which the land is located. The government has fixed the minimum wage payable to the workers. The entire operation will take three years and is estimated to cost €60 million. This amount will be spent as follows: €10 million each in the first and second years and €40 million in the third year. The fair value of this land is presently €120 million.

ABN Inc. would need to recognize the fair value of the grant over the period of three years in proportion to the cost of meeting the obligation. Thus, €120 million will be recognized as follows:

<u>Year</u>	<u>Grant recognized</u>
1	$€120 * (10/60) = €20$ million
2	$€120 * (10/60) = €20$ million
3	$€120 * (40/60) = €80$ million



4. Grants are sometimes received as part of a package of financial or fiscal aids to which a number of conditions are attached.

When different conditions attach to different components of the grant, the terms of the grant would have to be evaluated in order to determine how the various elements of the grant would be earned by the enterprise. Based on that assessment, the total grant amount would then be apportioned.

**Example of a grant received as part of financial aid subject to a number of conditions**

An enterprise receives a consolidated grant of €120 million. Two-thirds of the grant is to be utilized to purchase a college building for students from third-world or developing countries. The balance of the grant is for subsidizing the tuition costs of those students for four years from the date of the grant.

The grant would first be apportioned as follows:

Grant related to assets (2/3) = €80 million, and  
Grant related to income (1/3) = €40 million

The grant related to assets would be recognized in income over the useful life of the college building, for example, 10 years, using a systematic and rational basis. Assuming the college building is depreciated using the straight-line method, this portion of the grant (i.e., €80 million) would be recognized as income over a period of 10 years at €8 million per year.

The grant related to income would be recognized over a period of four years. Assuming that the tuition subsidy will be offered evenly over the period of four years, this portion of the grant (i.e., €40 million) would be taken to income over a period of four years at €10 million per year.

5. A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the enterprise with no future related costs should be recognized as income of the period in which it becomes receivable.

Sometimes grants are awarded for the purposes of giving immediate financial support to an enterprise, for example, to revive a commercial insolvent business (referred to as “sick unit” in some less-developed countries). Such grants are not given as incentives to invest funds in specified areas or for a specified purpose from which the benefits will be derived over a period of time in the future. Instead such grants are awarded to compensate an enterprise for losses incurred in the past. Thus, they should be recognized as income in the period in which the enterprise becomes eligible to receive such grants.

### **Non-Monetary Grants**

A government grant may not always be given in cash or cash equivalents. Sometimes a government grant may take the form of a transfer of a non-monetary asset, such as grant of a plot of land or a building in a remote area. In these circumstances the standard prescribes the following optional accounting treatments:

1. To account for both the grant and the asset at the fair value of the non-monetary asset; or
2. To record both the asset and the grant at a “nominal amount.”

## PRESENTATION AND DISCLOSURE

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### Presentation of Grants Related to Assets

#### *Presentation on the statement of financial position*

Government grants related to assets, including non-monetary grants at fair value, should be presented in the statement of financial position in either of two ways:

1. By setting up the grant as deferred income; or
2. By deducting the grant in arriving at the carrying amount of the asset.

**Example of setting up a grant as deferred income or reducing the carrying amount of the asset**

Natraj Corp. received a grant related to a factory building which it bought in 20XX. The total amount of the grant was €3 million. Natraj Corp. purchased the building from an industrialist identified by the government. The factory building was located in the slums of the city and was to be repossessed by a government agency from the industrialist, in case Natraj Corp. had not purchased it from him. The factory building was purchased for €9 million by Natraj Corp. The useful life of the building is not considered to be more than three years mainly because it was not properly maintained by the industrialist.

Under Option 1: Set up the grant as deferred income.

- The grant of €3 million would be set up initially as deferred income in 20XX.
- At the end of 20XX, €1 million would be recognized as income and the balance of €2 million would be carried forward in the statement of financial position.
- At the end of 20XX+1, €1 million would be taken to income and the balance of €1 million would be carried forward in the statement of financial position.
- At the end of 20XX+2, €1 million would be taken to income.

Under Option 2: The grant will be deducted from the carrying amount of the building.

The grant of €3 million is deducted from the gross carrying amount of the asset to arrive at the carrying amount of €6 million. The useful life being three years, annual depreciation of €2 million per year is charged to the income statement for the years 20XX, 20XX+1 and 20XX+2.

The effect on the operating results is the same whether the first or the second option is chosen.

Under the second option, the grant is indirectly recognized in income through the reduced depreciation charge of €1 million per year, whereas under the first option, it is taken to income directly.

#### *Presentation in the statement of cash flows*

When grants related to assets are received in cash, there is an inflow of cash to be shown under the investing activities section of the statement of cash flows. Furthermore, there would also be an outflow resulting from the purchase of the asset. IAS 20 specifically requires that both these movements should be shown separately and not be offset. The standard further clarifies that such movements should be shown separately regardless of whether or not the grant is deducted from the related asset for the purposes of the statement of financial position presentation.

## Presentation of Grants Related to Comprehensive Income

The standard allows a choice between two presentations.

Option 1: Grant presented as a credit in the statement of profit or loss and comprehensive income, either separately or under a general heading other income.

Option 2: Grant deducted in reporting the related expense.

The standard does not show any bias towards any one option. It acknowledges the reasoning given in support of each approach by its supporters. The standard considers both methods as acceptable. However, it does recommend disclosure of the grant for a proper understanding of the financial statements. The standard recognizes that the disclosure of the effect of the grants on any item of income or expense may be appropriate.

## Disclosures

The following disclosures are prescribed:

1. The accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;
2. The nature and extent of government grants recognized in the financial statements and an indication of other forms of government assistance from which the enterprise has directly benefited; and
3. Unfulfilled conditions and other contingencies attaching to government assistance that has been recognized.

## OTHER ISSUES

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### Repayment of Government Grants

When a government grant becomes repayable—for example, due to non-fulfillment of a condition attaching to it—it should be treated as a change in estimate, under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, and accounted for prospectively (as opposed to retrospectively).

Repayment of a grant related to income should:

1. First be applied against any unamortized deferred income (credit) set up in respect of the grant; and
2. To the extent the repayment exceeds any such deferred income (credit), or in case no deferred credit exists, the repayment should be recognized immediately as an expense.

Repayment of a grant related to an asset should be:

1. Recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable; and
2. The cumulative additional depreciation that would have been recognized to date as an expense in the absence of the grant should be recognized immediately as an expense.

When a grant related to an asset becomes repayable, it would become incumbent upon the enterprise to assess whether any impairment in value of the asset (to which the repayable grant relates) has resulted. For example, a bridge is being constructed through funding from

a government grant and during the construction period, because of non-fulfillment of the terms of the grant, the grant became repayable. Since the grant was provided to assist in the construction, it is possible that the enterprise may not be in a position to arrange funds to complete the project. In such a circumstance, the asset is impaired and may need to be written down to its recoverable value, in accordance with IAS 36.

#### Example of repayment of a government grant

During 20XX-2 Trident Corp invests €1,000,000 in an item of plant, which has an anticipated useful life of five years. Depreciation is recognized on a straight line basis. In the year of acquisition, Trident Corp receives a government grant of €250,000 towards the purchase of this plant, which is conditional on certain employment targets being achieved within the next three years (i.e. to the end of 20XX). At the end of 20XX, it is evident that the employment targets will not be achieved and therefore the criteria attached to the receipt of this grant has been failed. The grant becomes repayable and under the two methods of presentation of the grant, the treatment of the repayment is as follows:

#### Method A: Grant shown as deferred income

Grant received and credited in 20XX-2 to deferred income	€250,000
Recognized in profit or loss 20XX-2 to 20XX (3 × €50,000)	<u>(€150,000)</u>
Deferred income balance at end of 20XX before repayment of grant	<u>€100,000</u>
Total repayment of grant (cr bank)	<u>€250,000</u>
Repayment debited to deferred income balance (dr deferred income)	<u>(€100,000)</u>
Balance of repayment recognized in profit or loss (dr profit or loss)	<u>€150,000</u>

*Note: under this method the repayment does not impact the carrying amount of plant or depreciation expense recognized.*

#### Method B: Grant deducted from cost of asset

Cost of plant	€1,000,000
Less grant received	<u>(€ 250,000)</u>
Net cost of equipment	€ 750,000
Depreciation expense recognized 20XX-2 to 20XX (3 × €150,000)	<u>(€ 450,000)</u>
Carrying amount of plant at end of 20XX before repayment of grant	€ 300,000
Add back grant repayable	<u>€ 250,000</u>
	€ 550,000
Cumulative additional depreciation to be recognized in profit or loss for 20XX-2 to 20XX (3 × €50,000)	<u>€ 150,000</u>
Carrying amount of equipment at end of 20XX after repayment of grant	€ 400,000

#### Government Assistance

Under the provisions of IAS 20, government grants exclude government assistance. Government assistance is defined as action taken by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. IAS 20 deals with both accounting and disclosure of government grants and disclosure of government assistance. Thus government assistance comprises government grants and other forms of government assistance (i.e., those not involving transfer of resources).

Excluded from the government assistance are certain forms of government benefits that cannot reasonably have a value placed on them, such as free technical or other professional advice. Also excluded from government assistance are government benefits that cannot be distinguished from the normal trading transactions of the enterprise. The reason for the second exclusion is obvious: although the benefit cannot be disputed, any attempt to segregate it would necessarily be arbitrary.

## SERVICE CONCESSIONS

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Government involvement directly with business is much more common in Europe and elsewhere than in North America, and European adoption of IFRS has created a need to expand the IFRS literature to address a number of such circumstances. The *service concession*, particularly common in France, typically occurs when a commercial entity operates a commercial asset which is owned by, or has to be transferred to, a local, regional or national government organization. More generally, these arrangements exist when the public is provided with access to major economic or social facilities. The most famous example of this is perhaps the Channel Tunnel, linking England and France. This was built by a commercial entity which has a concession to operate it for a period of years, at the end of which time the asset reverts to the British and French governments. A more mundane example would be companies that erect bus shelters free of charge in municipalities, in return for the right to advertise on them for a period of time.

SIC 29, issued in 2001 as an interpretation of IAS 1, addressed only disclosures to be made for service concession arrangements. Under SIC 29, both the concession operator and the concession provider are directed to make certain disclosures in the notes to financial statements that purport to conform with IFRS. These disclosures include:

1. A description of the arrangement;
2. The significant terms of the arrangement that might affect the nature, timing or amounts of future cash flows, which could include terms and repricing dates and formulae;
3. The nature and the extent of rights to use specified assets; obligations to provide (or rights to expect) services; obligations to acquire or build property or equipment; options to deliver (or rights to receive) specific assets at the conclusion of the concession period; renewal and termination options; and other rights and obligations, such as for major overhauls of equipment; and
4. Changes to the concession arrangement occurring during the reporting period.

In 2006, the IASB issued IFRIC 12 to deal with the accounting for service concession arrangements. IFRIC 12 sets forth two accounting models, and stipulates how revenue is to be recognized.

### *Service concession arrangements*

Service concession arrangements are those whereby a government or other body grants contracts for the supply of public services (e.g., roads, energy distribution, prisons or hospitals) to private operators. The Interpretation draws a distinction between two types of service concession arrangements. In one, the operator receives a *financial asset*, specifically an unconditional contractual right to receive cash or another financial asset from the government in return for constructing or upgrading the public sector asset. In the other, the operator

receives an *intangible asset*—a right to charge for use of the public sector asset that it constructs or upgrades. The right to charge users is not an unconditional right to receive cash, because the amounts that might be received are contingent on the extent to which the public uses the service.

IFRIC 12 allows for the possibility that both types of arrangement may exist within a single contract: to the extent that the government has given an unconditional guarantee of payment for the construction of the public sector asset, the operator has a financial asset; to the extent that the operator has to rely on the public using the service in order to obtain payment, the operator has an intangible asset. The accounting to be applied is governed by the extent to which one or both types of assets are received.

#### ***Accounting under the financial asset model***

The operator recognizes a financial asset to the extent that it has an *unconditional* contractual right to receive cash or another financial asset from, or at the direction of, the grantor for the construction services. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator:

- Specified or determinable amounts; or
- The shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.

Under the provisions of IFRIC 12, the operator measures the financial asset at fair value.

#### ***Accounting under the intangible asset model***

The operator recognizes an intangible asset to the extent that it receives a right (a license) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

Under the provisions of IFRIC 12, the operator measures the intangible asset at fair value.

#### ***Operating revenue***

The operator of a service concession arrangement recognizes and measures revenue in accordance with IAS 11 or IAS 18 for the services it performs. No special revenue recognition principles are to be applied. Thus, the financial asset model would require the use of percentage of completion revenue recognition in most instances, while the intangible asset model would suggest that revenue be recognized as services are performed.

#### ***Accounting by the government (grantor)***

IFRIC 12 does not deal with the accounting to be applied by the government unit that grants service concession arrangements. That is because IFRS are not designed to apply to not-for-profit activities in the private sector or the public sector.

IFRIC 12 was made effective for annual periods beginning on or after January 1, 2008.

## **US GAAP COMPARISON**

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No specific US GAAP standard is issued regarding government grants and for-profit entities.

will be at rates above commercial lending rates, and, at the end of the lease term, usually some residual value.

The accounting for lease transactions involves a number of complexities, which derive partly from the range of alternative structures that are available to the parties. For example, in many cases leases can be configured to allow manipulation of the tax benefits, with other features such as lease term and implied interest rate adjusted to achieve the intended overall economics of the arrangement. Leases can be used to transfer ownership of the leased asset, and they can be used to transfer some or all of the risks normally associated with ownership. The financial reporting challenge is to have the economic substance of the transaction dictate the accounting treatment.

The accounting for lease transactions is one of the best examples of the application of the principle of substance over form, as set forth in the IASB's *Framework*. If the transaction effectively transfers ownership to the lessee, the substance of the transaction is that of a sale of the underlying property, which should be recognized as such even though the transaction takes the contractual form of a lease, which is only a right to use the property at issue.

The guidance on lease accounting under IFRS is not as fully elaborated as is that provided under certain national GAAP, consistent with the somewhat more "principles-based" approach of the international standards. Even applying such an approach, however, IFRS still does not result in the capitalization (treatment as assets and related debt) of all lease arrangements, and variations can be made to lease terms that can achieve operating (non-capitalization) treatment, which is often desired by lessees.

While almost any type of arrangement that satisfies the definition of a lease is covered by this standard, the following specialized types of lease agreements are specifically excluded:

1. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights.
2. Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

The accounting for rights to explore and develop natural resources has yet to be formally addressed by IFRS; IFRS 6, which deals with exploration and evaluation assets arising in the mineral exploration process, offers no accounting guidance for leases. Licensing agreements are addressed by IAS 38, which is discussed in Chapter 11.

<i>IAS 17, 24, 36</i>	<b>Sources of IFRS</b> <i>SIC 15, 27</i>	<i>IFRIC 4</i>
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## DEFINITIONS OF TERMS

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**Bargain purchase option (BPO).** A provision in the lease agreement allowing the lessee the option of purchasing the leased property for an amount that is sufficiently lower than the fair value of the property at the date the option becomes exercisable. Exercise of the option must appear reasonably assured at the inception of the lease.

**Contingent rentals.** Those lease rentals that are not fixed in amount but are based on a factor other than simply the passage of time; for example, if based on percentage of sales, price indices, market rates of interest, or degree of use of the leased asset.

**Economic life of leased property.** Either the period over which the asset is expected to be economically usable by one or more users, or the number of production or similar units expected to be obtained from the leased asset by one or more users.

**Executory costs.** Costs such as insurance, maintenance and taxes incurred for leased property, pertaining to the current period, whether paid by the lessor or lessee. If the obligation of the lessee, these are excluded from the minimum lease payments.

**Fair value of leased property (FMV).** The amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's-length transaction. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its normal selling price, net of any volume or trade discounts. When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost to the lessor, unless a significant amount of time has elapsed between the acquisition of the property by the lessor and the inception of the lease, in which case fair value should be determined in light of market conditions prevailing at the inception of the lease. Thus, fair value may be greater or less than the lessor's cost or the carrying amount of the property.

**Finance lease.** A lease that transfers substantially all the risks and rewards associated with the ownership of an asset. The risks related to ownership of an asset include the possibilities of losses from idle capacity or technological obsolescence, and that flowing from variations in return due to changing economic conditions; rewards incidental to ownership of an asset include an expectation of profitable operations over the asset's economic life and expectation of gain from appreciation in value or the ultimate realization of the residual value. Title may or may not eventually be transferred to the lessee under finance lease arrangements.

**Gross investment in the lease.** The sum total of (1) the minimum lease payments under a finance lease (from the standpoint of the lessor), plus (2) any unguaranteed residual value accruing to the lessor.

**Inception of the lease.** The date of the written lease agreement or, if earlier, the date of a commitment by the parties to the principal provisions of the lease.

**Initial direct costs.** Initial direct costs, such as commissions and legal fees, incurred by lessors in negotiating and arranging a lease. These generally include (1) costs to originate a lease incurred in transactions with independent third parties that (a) result directly from and are essential to acquire that lease, and (b) would not have been incurred had that leasing transaction not occurred; and (2) certain costs directly related to specified activities performed by the lessor for that lease, such as evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction.

**Lease.** An agreement whereby a lessor conveys to the lessee, in return for payment or series of payments, the right to use an asset (property, plant, equipment or land) for an agreed-upon period of time. Other arrangements essentially similar to leases, such as hire-purchase contracts, installment sale agreements, bare-boat charters and so on, are also considered leases for purposes of the standard.

**Lease term.** The initial non-cancelable period for which the lessee has contracted to lease the asset together with any further periods for which the lessee has the option to extend the lease of the asset, with or without further payment, which option it is reasonably certain (at the inception of the lease) that the lessee will exercise.

**Lessee's incremental borrowing rate.** The interest rate that the lessee would have to pay on a similar lease, or, if that is not determinable, the rate that at the inception of the lease the



lessee would have incurred to borrow over a similar term (i.e., a loan term equal to the lease term), and with a similar security, the funds necessary to purchase the leased asset.

### **Minimum Lease Payments (MLP)**

1. *From the standpoint of the lessee.* The payments over the lease term that the lessee is or can be required to make in connection with the leased property. The lessee's obligation to pay executory costs (e.g., insurance, maintenance or taxes) and contingent rents are excluded from minimum lease payments. If the lease contains a bargain purchase option, the minimum rental payments over the lease term plus the payment called for in the bargain purchase option are included in minimum lease payments.

If no such provision regarding a bargain purchase option is included in the lease contract, the minimum lease payments include the following:

- a. The minimum rental payments called for by the lease over the lease contract over the term of the lease (excluding any executory costs); plus
  - b. Any guarantee of residual value, at the expiration of the lease term, to be paid by the lessee or a party related to the lessee.
2. *From the standpoint of the lessor.* The payments described above plus any guarantee of the residual value of the leased asset by a third party unrelated to either the lessee or lessor (provided that the third party is financially capable of discharging the guaranteed obligation).

**Net investment in the lease.** The difference between the lessor's gross investment in the lease and the unearned finance income.

**Non-cancelable lease.** A lease that is cancelable only:

1. On occurrence of some remote contingency.
2. With the concurrence (permission) of the lessor.
3. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor.
4. On payment by the lessee of an additional amount such that at inception, continuation of the lease appears reasonably assured.

**Operating lease.** A lease that does not meet the criteria prescribed for a finance lease.

**Penalty.** Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to pay cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset, or otherwise forego an economic benefit or suffer an economic detriment.

**Rate implicit in the lease.** The discount rate that at the inception of the lease, when applied to the minimum lease payments, and the unguaranteed residual value accruing to the benefit of the lessor, causes the aggregate present value to be equal to the fair value of the leased property to the lessor.

**Related parties in leasing transactions.** Entities that are in a relationship where one party has the ability to control the other party or exercise significant influence over the operating and financial policies of the related party. Examples include the following:

1. A parent company and its subsidiaries.
2. An owner company and its joint ventures and partnerships.
3. An investor and its investees.

**Renewal or extension of a lease.** The continuation of a lease agreement beyond the original lease term, including a new lease where the lessee continues to use the same property.

**Residual value of leased property.** The fair value, estimated at the inception of the lease, that the enterprise expects to obtain from the leased property at the end of the lease term.

**Sale and leaseback accounting.** A method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its statement of financial position, recognizes gain or loss from the sale, and classifies the leaseback in accordance with IAS 17.

**Unearned finance income.** The excess of the lessor's gross investment in the lease over its present value.

**Unguaranteed residual value.** Part of the residual value of the leased asset (estimated at the inception of the lease) the realization of which by the lessor is not assured or is guaranteed by a party related to the lessor.

**Useful life.** The estimated period over which the economic benefits embodied by the asset are expected to be consumed, without being limited to the lease term.

## CLASSIFICATION OF LEASES

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### Classification of Leases—Lessee

For accounting and reporting purposes a lessee has two alternatives in classifying a lease:

1. Operating.
2. Finance.

Finance leases (which are known as *capital* leases under the corresponding US GAAP, because such leased property is treated as owned, and accordingly, capitalized in the statement of financial position) are those that essentially are alternative means of financing the acquisition of property or of substantially all the service potential represented by the property.

The proper classification of a lease is determined by the circumstances surrounding the leasing transaction. According to IAS 17, whether a lease is a finance lease or not will have to be judged based on the *substance* of the transaction, rather than on its mere *form*. If substantially all of the benefits and risks of ownership have been transferred to the lessee, the lease should be classified as a finance lease; such a lease is normally non-cancelable and the lessor is assured (subject to normal credit risk) of recovery of the capital invested plus a reasonable return on its investment. IAS 17 stipulates that substantially all of the risks or benefits of ownership are deemed to have been transferred if *any one* of the following five criteria has been met:

1. The lease transfers ownership to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option (an option to purchase the leased asset at a price that is expected to be substantially lower than the fair value at the date the option becomes exercisable) and it is reasonably certain that the option will be exercisable.
3. The lease term is for the *major part* of the economic life of the leased asset.

4. The present value (PV), at the inception of the lease, of the minimum lease payments is at least equal to *substantially all* of the fair value of the leased asset, net of grants and tax credits to the lessor at that time; title may or may not eventually pass to the lessee.
5. The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

Further indicators which suggest that a lease *might* be properly considered to be a finance lease are:

6. If the lessee can cancel the lease, the lessor's losses that are associated with the cancellation are to be borne by the lessee.
7. Gains or losses resulting from the fluctuations in the fair value of the residual will accrue to the lessee.
8. The lessee has the ability to continue the lease for a supplemental term at a rent that is substantially lower than market rent (i.e., there is a bargain renewal option).

Thus, under IAS 17, an evaluation of all eight of the foregoing criteria would be required to properly assess whether there is sufficient evidence to conclude that a given arrangement should be accounted for as a finance lease. Of the eight criteria set forth in the standard, the first five are essentially determinative in nature; that is, meeting *any one* of these would normally result in concluding that a given arrangement is in fact a finance lease. The final three criteria, however, are more suggestive in nature, and the standard states that these could lead to classification as a finance lease.

The interest rate used to compute the present value should be the lessee's *incremental borrowing rate*, unless it is practicable to determine the rate *implicit* in the lease, in which case that implicit rate should be used.

The language used in the third and fourth lease accounting criteria, as set forth above, makes them rather subjective and somewhat difficult to apply in practice. Thus, given the same set of facts, it is possible for two reporting entities to reach different conclusions regarding the classification of a given lease.

The purpose of the third criterion is to define leases covering essentially all of the asset's useful life as being financing arrangements. Under the current US GAAP standard, a clearly defined threshold of 75% of the useful life has been specified as one of the criteria for classifying a lease as a finance lease, which thus creates a "bright line" test that can be applied mechanically. The corresponding language under IAS 17 stipulates that capitalization results when the lease covers a "major part of the economic life" of the asset. Reasonable persons obviously can debate whether "major part" implies a proportion lower than 75% (say, as little as 51%), or implies a higher proportion (such as 90%). It should be noted that the previous version of IAS 17 had these "bright lines" in the standard, but these were removed in favour of a more principle-based approach.

The fourth criterion defines what are essentially arrangements to fully compensate the lessor for the entire value of the leased property as financing arrangements. In contrast to US GAAP, this quantitative threshold is not provided under IFRS. A threshold, "the present value of minimum lease payments equaling at least 90% of leased asset fair value," is set as one of the criteria under the US standard, while the corresponding language, "substantially all of the fair value of the leased asset," is employed under IFRS. Again, there is room for debate over whether "substantially all" implies a threshold lower than 90% or, less likely, an

even higher one. Once again, the IASB chose to remove the 90% from the previous IAS 17 standard.

IAS 17 addresses the issue of change in lease classification resulting from alterations in lease terms, stating that if the parties agree to revise the terms of the lease, other than by means of renewing the lease, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at inception of the lease, then the revised lease is to be considered a new lease agreement.

### **Leases Involving Land and Buildings**

IAS 17 addresses leases involving both land and buildings. In general, the accounting treatment of such leases is the same as for simple leases of other types of assets. Prior to the most recent revisions to IAS 17, the standard required that leases for land and buildings be analysed into their component parts, with each element separately accounted for, unless title to both elements is expected to pass to the lessee by the end of the lease term. It continued the operating lease treatment requirement for the land portion of the lease, unless title is expected to pass to the lessee by the end of the lease term, in which case finance lease treatment is warranted. The buildings element is to be classified as a finance or operating lease in accordance with IAS 17's provisions.

However, the *Improvements Project 2009* resulted in an amendment that revised IAS 17 regarding this issue. Under the revised standard, the above guidance was removed from IAS 17. This had the effect of requiring a lessee to analyse both the land and building components of the lease separately to determine whether each component was a finance or operating lease. The presumption that land was always an operating lease unless ownership passed was removed. The standard does, however, state that when analysing a land lease under the IAS 17 requirements, the criteria requiring that the lease be for the majority of the useful life would probably not be met as land has an indefinite economic life.

Under IAS 17, the minimum lease payments at the inception of a lease of land and buildings (including any up-front payments) are to be allocated between the land and the buildings elements in proportion to their relative fair values at the inception of the lease. In those circumstances where the lease payments cannot be allocated reliably between these two elements, the entire lease is to be classified as a finance lease, unless it is clear that both elements are operating leases.

Furthermore, IAS 17 specifies that for a lease of land and buildings in which the value of the land element at the inception of the lease is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification, in which case the criteria set forth in IAS 17 will govern the classification as a finance or operating lease. If this is done, the economic life of the buildings is regarded as the economic life of the entire leased asset.

Additional guidance, drawn from US GAAP, and an example of accounting for a combined land and building lease, are presented in Appendix A.

### **Classification of Leases—Lessor**

The lessor has the following alternatives in classifying a lease:

1. Operating lease.
2. Finance lease.

***Consistent accounting by lessee and lessor***

Since the events or transactions that take place between the lessor and the lessee are based on an agreement (the lease) that is common to both the parties, it is normally appropriate that the lease be classified in a consistent manner by both parties. Thus, if the requirements listed above result in classification of a lease as a finance lease by the lessee, the lease should also be classified as a finance lease by the lessor. However, as the standard does require judgement to be applied when assessing lease classification, in practice the accounting treatment may differ between lessor and lessee. Of course, neither party to the lease can control whether the other applies proper accounting to the transaction.

Notwithstanding this general observation, IAS 17 alludes to an exception to this rule when it speaks about the “differing circumstances” sometimes resulting in the same lease being classified differently by the lessor and lessee. This could occur, for example, when the lessor benefits by having a third-party residual value guarantee in place. The standard does not elaborate on such circumstances.

**Different Types of Finance Leases**

Finance leases can have various forms. Some common examples are sales-type, direct financing and leveraged leases.

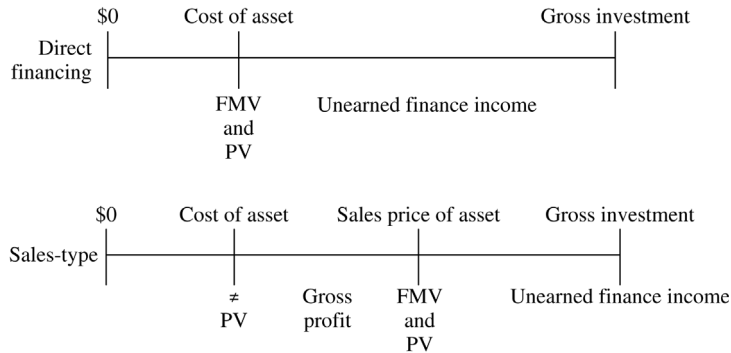
A lease is classified as a sales-type lease when the criteria set forth above have been met and the lease transaction is structured such that the lessor (generally a manufacturer or dealer) recognizes a profit or loss on the transaction in addition to interest revenue. For this to occur, the fair value of the property, or if lower, the sum of the present values of the minimum lease payments and the estimated unguaranteed residual value, must differ from the cost (or carrying value, if different). The essential substance of this transaction is that of a sale, thus its name. Common examples of sales-type leases: (1) when an automobile dealership opts to lease a car to its customers in lieu of making an actual sale, and (2) the re-lease of equipment coming off an expiring lease.

A direct financing lease differs from a sales-type lease in that the lessor does not realize a profit or loss on the transaction other than the interest revenue to be earned over the lease term. In a direct financing lease, the fair value of the property at the inception of the lease is equal to the cost (or carrying value, if the property is not new). This type of lease transaction most often involves entities regularly engaged in financing operations. The lessor (usually a bank or other financial institution) purchases the asset and then leases the asset to the lessee. This mode of transaction is merely a replacement for the conventional lending transaction, where the borrower uses the borrowed funds to purchase the asset.

There are many economic reasons why a lease transaction may be considered. These include:

1. The lessee (borrower) is often able to obtain 100% financing.
2. There may be tax benefits for the lessee, such as the ability to expense the asset over its lease term, instead of over a longer depreciable life.
3. The lessor receives the equivalent of interest as well as an asset with some remaining value at the end of the lease term (unless title transfers as a condition of the lease).
4. The lessee is protected from risk of obsolescence (although presumably this risk protection is priced into the lease terms).

In summary, it may help to visualize the following chart when considering the classification of a lease:



One specialized form of a direct financing lease is a *leveraged lease*. This type is mentioned separately both here and in the following section on how to account for leases because it is to receive a different accounting treatment by a lessor. A leveraged lease meets all the definitional criteria of a direct financing lease, but differs because it involves at least three parties: a lessee, a long-term creditor and a lessor (commonly referred to as the equity participant). Other characteristics of a leveraged lease are as follows:

1. The financing provided by the long-term creditor must be without recourse as to the general credit of the lessor, although the creditor may hold recourse with respect to the leased property. The amount of the financing must provide the lessor with substantial leverage in the transaction.
2. The lessor's net investment declines during the early years and rises during the later years of the lease term before its elimination.

## RECOGNITION AND MEASUREMENT

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### Accounting for Leases—Lessee

As discussed in the preceding section, there are two classifications under IAS 17 that apply to a lease transaction in the financial statements of the lessee. They are as follows:

1. Operating.
2. Finance.

#### *Operating leases*

The accounting treatment accorded an operating lease is relatively simple; rental expense should be charged to profit or loss as the payments are made or become payable. IAS 17 stipulates that rental expense be “recognized on a systematic basis that is representative of the time pattern of the user’s benefits, even if the payments are not on that basis.” In many cases, the lease payments are being made on a straight-line basis (i.e., equal payments per period over the lease term), and recognition of rental expense would normally also be on a straight-line basis.

However, even if the lease agreement calls for an alternative payment schedule or a scheduled rent increase over the lease term, the lease expense should still be recognized on a

straight-line basis unless another systematic and rational basis is a better representation of actual physical use of the leased property. In such instances it will be necessary to create either a prepaid asset or a liability, depending on the structure of the payment schedule. In SIC 15, it has been held that all incentives relating to a new or renewed operating lease are to be considered in determining the total cost of the lease, to be recognized on a straight-line basis over the term of the lease. Thus, for example, a rent holiday for six months, offered as part of a five-year lease commitment, would not result in the reporting of only six months' rent expense during the first full year. Rather, four and one-half years' rent would be allocated over the full five-year term, such that monthly expense would equal 90% (=54 months' payments/60-month term) of the stated monthly rental payments that begin after the holiday ends. This accounting method would apply to both lessor and lessee.

The accounting would differ if rental increases were directly tied to expanded space utilization, however, but not if related merely to the extent that the property were being used. For example, if the lease agreement provides for a scheduled increase(s) in contemplation of the lessee's increased (i.e., more intensive) physical use of the leased property (e.g., more sustained usage of machinery after an initial set-up period), the total amount of rental payments, including the scheduled increase(s), should be charged to expense over the lease term on a straight-line basis; the increased rent should not impact the accounting. On the other hand, if the scheduled increase(s) is due to additional leased property (e.g., expanding to adjacent space after two years), recognition should be proportional to the amount of leased property, with the increased rents recognized over the years that the lessee has control over the use of the additional leased property. Scheduled increases could envision more than one of these events occurring, making the accounting more complex.

Notice that in the case of an operating lease there is no recognition in the statement of financial position of the leased asset because the substance of the lease is merely that of a rental. There is no reason to expect that the lessee will derive any future economic benefit from the leased asset beyond the lease term. There may, however, be a deferred charge or credit in the statement of financial position if the payment schedule under terms of the lease does not correspond with the expense recognition, as suggested in the preceding paragraph.

#### Example of straight lining of lease payments

Rockwood Limited has 2 leases:

Lease 1:

3-year lease

Lease payment \$100,000 p.a. escalating at inflation

Inflation for years 1–3 is 8%

Lease 2:

3-year lease

Lease payment \$100,000 p.a. escalating at 8% p.a. to reflect inflation

Inflation for years 1–3 is  $\pm 8\%$

#### Accounting for Lease 1:

##### Year 1

Statement of Comprehensive Income – Lease Expense	100,000	
Bank		100,000

**Year 2**

Statement of Comprehensive Income – Lease Expense	108,000	
Bank		108,000

**Year 3**

Statement of Comprehensive Income – Lease Expense	116,640	
Bank		116,640

**Accounting for Lease 2:**

As the escalation is a fixed percentage, and not a contingent amount as per Lease 1 (note that inflation is considered contingent), then the lease payments must be straight lined. Note that the difference between the amount charged to the statement of comprehensive income and the amount paid to the lessor should be recognized in the statement of financial provision as a liability.

Total lease payments over lease term:

Year 1		100,000
Year 2		108,000
Year 3		<u>116,640</u>
Total		324,640

Therefore the annual charge will be  $324,640/3 =$  108,213

**Year 1**

Statement of Comprehensive Income – Lease Expense	108,213	
Bank		100,000
Operating Lease Provision (SoFP)		8,213

**Year 2**

Statement of Comprehensive Income – Lease Expense	108,213	
Bank		108,000
Operating Lease Provision (SoFP)		213

**Year 3**

Statement of Comprehensive Income – Lease Expense	108,214	
Bank		116,640
Operating Lease Provision (SoFP)		8,426

**Finance leases.** Assuming that the lease agreement satisfies the criteria set forth above for finance lease accounting, it must be accounted for as a finance lease.

According to IAS 17, the lessee is to record a finance lease as an asset and an obligation (liability) at an amount equal to the lesser of (1) the fair value of the leased property at the inception of the lease, net of grants and tax credits receivable by the lessors, or (2) the present value of the minimum lease payments.

For purposes of this computation, the minimum lease payments are considered to be the payments that the lessee is obligated to make or can be required to make, excluding contingent rent and executory costs such as insurance, maintenance and taxes. The minimum lease payments generally include the minimum rental payments, and any guarantee of the residual value made by the lessee or a party related to the lessee. If the lease includes a bargain purchase option (“BPO”), the amount required to be paid under the BPO is included in the minimum lease payments. The present value shall be computed using the incremental borrowing rate of the lessee unless it is practicable for the lessee to determine the



implicit rate computed by the lessor, in which case it is to be employed, whether higher or lower than the incremental borrowing rate.

The lease term to be used in the present value computation is the fixed, non-cancelable term of the lease, plus any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, provided that it is reasonably certain, as of the beginning of the lease, that the lessee will exercise such a renewal option.

**Depreciation of leased assets.** The depreciation of the leased asset will depend on which criterion resulted in the lease being qualified as a finance lease. If the lease transaction met the criteria as either transferring ownership or containing a bargain purchase option, the asset arising from the transaction is to be depreciated over the estimated useful life of the leased property, which will, after all, be used by the lessee (most likely) after the lease term expires. If the transaction qualifies as a finance lease because it met either the criterion of encompassing the major part of the asset's economic life, or because the present value of the minimum lease payments represented substantially all of the fair value of the underlying asset, then it must be depreciated over the shorter of the lease term or the useful life of the leased property. The conceptual rationale for this differentiated treatment arises because of the substance of the transaction. Under the first two criteria, the asset actually becomes the property of the lessee at the end of the lease term (or on exercise of the BPO). In the latter situations, title to the property remains with the lessor.

Thus, the leased asset is to be depreciated (amortized) over the shorter of the lease term or its useful life if title does not transfer to the lessee, but when it is reasonably certain that the lessee will obtain ownership by the end of the lease term, the leased asset is to be depreciated over the asset's useful life. The manner in which depreciation is computed should be consistent with the lessee's normal depreciation policy for other depreciable assets owned by the lessee, recognizing depreciation on the basis set out in IAS 16. Therefore, the accounting treatment and method used to depreciate (amortize) the leased asset is very similar to that used for an owned asset.

In some instances when the property is to revert back to the lessor, there may be a guaranteed residual value. This is the value at lease termination that the lessee guarantees to the lessor. If the fair value of the asset at the end of the lease term is greater than or equal to the guaranteed residual amount, the lessee incurs no additional obligation. On the other hand, if the fair value of the leased asset is less than the guaranteed residual value, the lessee must make up the difference, usually with a cash payment. The guaranteed residual value is often used as a device to reduce the periodic payments by substituting the lump-sum amount at the end of the term that results from the guarantee. In any event the depreciation (amortization) must still be based on the estimated residual value. This results in a rational and systematic allocation of the expense through the periods and avoids having to recognize a disproportionately large expense (or loss) in the last period as a result of the guarantee.

The annual (periodic) rent payments made during the lease term are to be apportioned between the reduction in the obligation and the finance charge (interest expense) in a manner such that the finance charge (interest expense) represents a constant periodic rate of interest on the remaining balance of the lease obligation. This is commonly referred to as the *effective rate* interest method. However, it is to be noted that IAS 17 also recognizes that an approximation of this pattern can be made, as an alternative. The

effective rate method, which is used in many other applications, such as mortgage amortization, is almost universally understood, and therefore should be applied in virtually all cases.

At the inception of the lease the asset and the liability relating to the future rental obligation are reported in the statement of financial position of the lessee at the same amounts. However, since the depreciation charge for use of the leased asset and the finance expense during the lease term differ due to different policies being used to recognize them, as explained above, it is likely that the asset and related liability balances would not be equal in amount after inception of the lease.

The following examples illustrate the treatment described in the foregoing paragraphs:

**Example of accounting for a finance lease—asset returned to lessor at termination**

Assume the following:

1. The lease is initiated on January 1, 20XX, for equipment with an expected useful life of three years. The equipment reverts back to the lessor on expiration of the lease agreement.
2. The FMV of the equipment is €135,000.
3. Three payments are due to the lessor in the amount of €50,000 per year beginning December 31, 20XX. An additional sum of €1,000 is to be paid annually by the lessee for insurance.
4. Lessee guarantees a €10,000 residual value on December 31, 20XX+2, to the lessor.
5. Irrespective of the €10,000 residual value guarantee, the leased asset is expected to have only a €1,000 salvage value on December 31, 20XX+2.
6. The lessee's incremental borrowing rate is 10% (implicit rate is unknown).
7. The present value of the lease obligation is as follows:

$$\begin{array}{rclcl}
 \text{PV of guaranteed residual value} & = & \text{€}10,000 \times 0.7513^* & = & \text{€ } 7,513 \\
 \text{PV of annual payments} & = & \text{€}50,000 \times 2.4869^{**} & = & \underline{124,345} \\
 & & & & \text{€}131,858
 \end{array}$$

\*The present value of an amount of €1 due in three periods at 10% is 0.7513.

\*\*The present value of an ordinary annuity of €1 for three periods at 10% is 2.4869.

The first step in accounting for any lease transaction is to classify the lease. In this case, the lease term is for three years, which is equal to 100% of the expected useful life of the asset. Notice that the test of fair value versus present value is also fulfilled, as the PV of the minimum lease payments (€131,858) could easily be considered as being equal to substantially all the FMV (€135,000), being equal to 97.7% of the FMV. Thus, this lease should be accounted for as a finance lease.

In assumption 7 above, the present value of the lease obligation is computed. Note that the executory costs (insurance) are not included in the minimum lease payments and that the incremental borrowing rate of the lessee was used to determine the present value. This rate was used because the implicit rate was not determinable.

The entry necessary to record the lease on January 1, 20XX is:

Leased equipment	131,858	
Lease obligation		131,858

Note that the lease is recorded at the present value of the minimum lease payments, which in this case is less than the fair value of the asset. If the present value of the minimum lease payments had exceeded the fair value, the lease would be recorded at the fair value.

The next step is to determine the proper allocation between interest and a reduction in the lease obligation for each lease payment. This is done using the effective interest method as illustrated below.

<u>Year</u>	<u>Cash payment</u>	<u>Interest expense</u>	<u>Reduction in lease obligation</u>	<u>Balance of lease obligation</u>
Inception of lease				€131,858
1	€50,000	€13,186	€36,814	€95,044
2	€50,000	€9,504	€40,496	€54,548
3	€50,000	€5,452	€44,548	€10,000

The interest is calculated at 10% (the incremental borrowing rate) of the balance of the lease obligation for each period, and the remainder of the €50,000 payment is allocated to a reduction in the lease obligation. The lessee is also required to pay €1,000 for insurance on an annual basis. The entries necessary to record all payments relative to the lease for each of the three years are shown below.

	<u>December 31, 20XX</u>	<u>December 31, 20XX+1</u>	<u>December 31, 20XX+2</u>
Insurance expense	1,000	1,000	1,000
Interest expense	13,186	9,504	5,452
Lease obligation	36,184	40,496	44,548
Cash	51,000	51,000	51,000

The leased equipment recorded as an asset must also be amortized (depreciated). The balance of this account is €131,858; however, as with any other asset, it cannot be depreciated below the estimated residual value of €1,000 (note that it is depreciated down to the actual estimated residual value, *not* the guaranteed residual value). In this case, the straight-line depreciation method is applied over a period of three years. This three-year period represents the lease term, *not* the life of the asset, because the asset reverts back to the lessor at the end of the lease term. Therefore, the following entry will be made at the end of each year:

Depreciation expense	43,619	
Accumulated depreciation		43,619 [(€131,858 – €1,000) ÷ 3]

Finally, on December 31, 20XX+2, we must recognize the fact that ownership of the property has reverted back to the owner (lessor). The lessee made a guarantee that the residual value would be €10,000 on December 31, 20XX+2; as a result, the lessee must make up the difference between the guaranteed residual value and the actual residual value with a cash payment to the lessor. The following entry illustrates the removal of the leased asset and obligation from the books of the lessee:

Lease obligation	10,000	
Accumulated depreciation	130,858	
Cash		9,000
Leased equipment		131,858

The foregoing example illustrated a situation where the asset was to be returned to the lessor. Another situation exists (where there is a bargain purchase option or automatic transfer of title) where the asset is expected to remain with the lessee. Recall that, under IAS 17, leased assets are amortized over their useful life when title transfers or a bargain purchase option exists. In such a circumstance, the lease liability may not be amortized completely as of the termination date of the lease. At the end of the lease, the balance of the lease obligation should equal the guaranteed residual value, the bargain purchase option price, or a termination penalty.

**Example of accounting for a finance lease—asset ownership transferred to lessee and fair market value of leased asset lower than present value of minimum lease payments**

Assume the following:

1. A three-year lease is initiated on January 1, 20XX, for equipment with an expected useful life of five years.
2. Three annual lease payments of €52,000 are required beginning on January 1, 20XX (note that the payment at the beginning of the year changes the PV computation). The lessor pays €2,000 per year for insurance on the equipment.
3. The lessee can exercise a bargain purchase option on December 31, 20XX+2, for €10,000. The expected residual value at December 31, 20XX+4 is €1,000.
4. The lessee's incremental borrowing rate is 10% (implicit rate is unknown).
5. The fair market value of the property leased is €140,000.

Once again, the classification of the lease must take place prior to the accounting for it. This lease is classified as a finance lease because it contains a bargain purchase option (BPO). Note that in this case, the PV versus FMV test is also clearly fulfilled.

The PV of the lease obligation is computed as follows:

PV of bargain purchase option	= €10,000	× 0.7513*	=	€7,513
PV of annual payments	= (€52,000 – €2,000)	× 2.7355**	=	136,755
				<b>€144,288</b>

\*The present value of an amount of €1 due in three periods at 10% is 0.7513.

\*\*The present value of an annuity due of €1 for three periods at 10% is 2.7355.

Notice that in the example above, the present value of the lease obligation is greater than the fair value of the asset. Also notice that since the lessor pays €2,000 a year for insurance, this payment is treated as executory costs and hence excluded from calculation of the present value of annual payments. Since the PV is greater than the fair value, the lease obligation (as well as the leased asset) must be recorded at the fair value of the asset leased (being the lower of the two). The entry on January 1, 20XX is as follows:

Leased equipment	140,000	
Obligation under finance lease		140,000

According to IAS 17, the apportionment between interest and principal is to be such that interest recognized reflects the use of a constant periodic rate of interest applied to the remaining balance of the obligation. When the PV exceeds the fair value of the leased asset, a new, effective rate must be computed which will be applied to the liability. Note, however, that if an impairment were subsequently recognized on the asset as an expense in the period of the impairment, following the procedures set forth in IAS 36, this would not affect the recorded amount of the lease obligation (i.e., the liability) and thus would not alter the initially determined interest rate. In this example, the interest rate was determined to be 13.265%. The amortization of the lease takes place as follows:

<u>Year</u>	<u>Cash</u> <u>payment</u>	<u>Interest</u> <u>Expense</u>	<u>Reduction in</u> <u>lease obligation</u>	<u>Balance of</u> <u>lease obligation</u>
Inception of lease				€140,000
January 1, 20XX	€50,000	€ –	€50,000	90,000
January 1, 20XX+1	50,000	11,939	38,061	51,939
January 1, 20XX+2	50,000	6,890	43,110	8,829
December 31, 20XX+2	10,000	1,171	8,829	–

The following entries are required in years 20XX through 20XX+2 to recognize the payment and depreciation (amortization).

		<u>20XX</u>	<u>20XX+1</u>	<u>20XX+2</u>	
January 1	Operating expense	2,000	2,000	2,000	
	Obligation under finance lease	50,000	38,061	43,110	
	Accrued interest payable		11,939	6,890	
	Cash	52,000	52,000		52,000
December 31	Interest expense	11,939	6,890	1,171	
	Accrued interest payable	11,939	6,890		
	Obligation under finance lease				1,171
December 31	Depreciation expense	27,800	27,800	27,800	
	Accumulated depreciation (€139,000, five years)	27,800	27,800	27,800	
December 31	Obligation under finance lease			10,000	
	Cash				10,000

### ***Impairment of leased asset***

IAS 17 did not originally address the issue of how impairments of leased assets are to be assessed or, if determined to have occurred, how they would need to be accounted for. Subsequently, IAS 17 was revised to note that the provisions of IAS 36 should be applied to leased assets in the same manner as they would be applied to owned assets. Impairments to the leased asset (occurring after the inception of the lease) are recognized by charges to expense in the current reporting period. IAS 36 is discussed more fully in Chapter 9.

### **Accounting for Leases—Lessor**

As illustrated above, there are two classifications of leases with which a lessor must be concerned:

1. Operating.
2. Finance.

#### ***Operating leases***

As is the case for the lessee, the operating lease requires a less complex accounting treatment than does a finance lease. The payments received by the lessor are to be recorded as rental income in the period in which the payment is received or becomes receivable. As with the lessee, if the rentals vary from a straight-line basis, or if the lease agreement contains a scheduled rent increase over the lease term, the revenue is nonetheless to be recognized on a straight-line basis unless an alternative basis of systematic and rational allocation is more representative of the time pattern of earning process contained in the lease.

Additionally, if the lease agreement provides for a scheduled increase(s) in contemplation of the lessee's increased (i.e., more intensive) physical use of the leased property, the total amount of rental payments, including the scheduled increase(s), is allocated to revenue over the lease term on a straight-line basis. However, if the scheduled increase(s) is due to additional leased property (e.g., larger space, more machines), recognition should be proportional to the leased property, with the increased rents recognized over the years that the lessee has control over use of the additional leased property.

Under the leasing standard all initial direct costs incurred must be added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis

as the lease income. Initial direct costs are incurred by lessors in negotiating and arranging an operating lease, and may include commissions, legal fees and those internal costs that are actually incremental (i.e., would not exist if the lease were not being negotiated) and directly attributable to negotiating and arranging the lease.

Although there is no guidance on this matter under IFRS, logically any incentives granted by the lessor to the lessee are to be treated as reductions of rent and recognized on a straight-line basis over the term of the lease.

Depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets, and the depreciation expense should be computed on the basis set out in IAS 16.

#### Example of straight lining of lease income

SandStone PLC leases 2 buildings to Rockwood Limited. The details are as follows:

Lease 1:

3-year lease

Lease payment \$100,000 p.a. escalating at inflation

Inflation for years 1–3 is 8%

Lease 2:

3-year lease

Lease payment \$100,000 p.a. escalating at 8% p.a. to reflect inflation

Inflation for years 1–3 is –8%

#### *Accounting for Lease 1:*

##### **Year 1**

Bank	100,000	
Statement of Comprehensive Income – Lease Income		100,000

##### **Year 2**

Bank	108,000	
Statement of Comprehensive Income – Lease Income		108,000

##### **Year 3**

Bank	116,640	
Statement of Comprehensive Income – Lease Income		116,640

#### *Accounting for Lease 2:*

As the escalation is a fixed percentage, and not a contingent amount as per Lease 1 (note that inflation is considered contingent), then the lease income must be straight lined. Note that the difference between the amount charged to the statement of comprehensive income and the amount received from the lessee should be recognized in the statement of financial provision as an asset.

Total lease payments over lease term:

Year 1	100,000
Year 2	108,000
Year 3	<u>116,640</u>
Total	<u>324,640</u>

Therefore the annual charge will be  $324,640/3 =$

108,213

**Year 1**

Bank	100,000	
Operating Lease Provision (SoFP)	8,213	
Statement of Comprehensive Income – Lease Income		108,213

**Year 2**

Bank	108,000	
Operating Lease Provision (SoFP)	213	
Statement of Comprehensive Income – Lease Income		108,213

**Year 3**

Bank	116,640	
Operating Lease Provision (SoFP)		8,426
Statement of Comprehensive Income – Lease Income		108,214

***Finance leases***

The accounting by the lessor for finance leases depends on which variant of finance lease is at issue. In sales-type leases, an initial profit, analogous to that earned by a manufacturer or dealer, is recognized, whereas a direct financing lease does not give rise to an initial recognition of profit.

***Sales-type leases***

In the accounting for a sales-type lease, it is necessary for the lessor to determine the following amounts:

1. Gross investment.
2. Fair value of the leased asset.
3. Cost.

From these amounts, the remainder of the computations necessary to record and account for the lease transaction can be made. The first objective is to determine the numbers necessary to complete the following entry:

Lease receivable	xx	
Cost of goods sold	xx	
Sales		xx
Inventory		xx
Unearned finance income		xx

The gross investment (lease receivable) of the lessor is equal to the sum of the minimum lease payments (excluding contingent rent and executory costs) from the standpoint of the lessor, plus the unguaranteed residual value accruing to the lessor. The difference between the gross investment and the present value of the two components of gross investment (i.e., minimum lease payments and unguaranteed residual value) is recorded as “unearned finance income” (also referred to as “unearned interest revenue”). The present value is to be computed using the lease term and implicit interest rate (both of which were discussed earlier).

IAS 17 stipulates that the resulting unearned finance income is to be amortized and recognized into income using the effective rate (or yield) interest method, which will result in a constant periodic rate of return on the “lessor’s net investment” (which is computed as the “lessor’s gross investment” less the “unearned finance income”).

Recall that the fair value of the leased property is by definition equal to the normal selling price of the asset adjusted by any residual amount retained (including any unguaranteed residual value, investment credit, etc.). According to IAS 17, the selling price to be used for a sales-type lease is equal to the fair value of the leased asset, or if lower, the sum of the present values of the MLP and the estimated unguaranteed residual value accruing to the lessor, discounted at a commercial rate of interest. In other words, the normal selling price less the present value of the unguaranteed residual value is equal to the present value of the MLP. (Note that this relationship is sometimes used while computing the MLP when the normal selling price and the residual value are known; this is illustrated in a case study that follows.)

Under IAS 17, initial direct costs incurred in connection with a sales-type lease (i.e., where the lessor is a manufacturer or dealer) must be expensed as incurred. This is a reasonable requirement, since these costs offset some of the profit recognized at inception, as do other selling expenses. Thus, the costs recognized at the inception of such lease arrangements would include the carrying value of the equipment or other items being leased, as well as incidental costs of negotiating and executing the lease. The profit recognized at inception would be the gross profit on the sale of the leased asset, less all operating costs, including the initial direct costs of creating the lease arrangement.

The estimated unguaranteed residual values used in computing the lessor's gross investment in a lease should be reviewed regularly. In case of a permanent reduction (impairment) in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction with respect to amounts already accrued is recognized immediately.

To attract customers, manufacturer or dealer lessors sometimes quote artificially low rates of interest. This has a direct impact on the recognition of initial profit, which is an integral part of the transaction and is inversely proportional to the finance income to be generated by it. Thus, if finance income is artificially low, this results in recognition of excessive profit from the transaction at the time of the sale. Under such circumstances, the standard requires that the profit recognized at inception, analogous to a cash sale of the leased asset, be restricted to that which would have resulted had a commercial rate of interest been used in the deal. Thus, the substance, not the form, of the transaction should be reflected in the financial statements. The present value of the scheduled lease payments, discounted at the appropriate commercial rate, must be computed to derive the effective selling price of the leased asset under these circumstances.

The difference between the selling price and the amount computed as the cost of goods sold is the gross profit recognized by the lessor on the inception of the lease (sale). Manufacturer or dealer lessors often give an option to their customers of either leasing the asset (with financing provided by them) or buying the asset outright. Thus, a finance lease by a manufacturer or dealer lessor, also referred to as a sales-type lease, generates two types of revenue for the lessor:

1. The gross profit (or loss) on the sale, which is equivalent to the profit (or loss) that would have resulted from an outright sale at normal selling prices, adjusted if necessary for a non-commercial rate of interest.
2. The finance income or interest earned on the lease receivable to be spread over the lease term based on a pattern reflecting a constant periodic rate of return on either the lessor's net investment outstanding or the net cash investment outstanding in respect of the finance lease.



The application of these points is illustrated in the example below.

**Example of accounting for a sales-type lease**

XYZ Inc. is a manufacturer of specialized equipment. Many of its customers do not have the necessary funds or financing available for outright purchase. Because of this, XYZ offers a leasing alternative. The data relative to a typical lease are as follows:

1. The non-cancelable fixed portion of the lease term is five years. The lessor has the option to renew the lease for an additional three years at the same rental. The estimated useful life of the asset is 10 years. The lessee guarantees a residual value of €40,000 at the end of five years, but the guarantee lapses if the full three-year renewal period is exercised.
2. The lessor is to receive equal annual payments over the term of the lease. The leased property reverts back to the lessor on termination of the lease.
3. The lease is initiated on January 1, 20XX. Payments are due on December 31 for the duration of the lease term.
4. The cost of the equipment to XYZ Inc. is €100,000. The lessor incurs cost associated with the inception of the lease in the amount of €2,500.
5. The selling price of the equipment for an outright purchase is €150,000.
6. The equipment is expected to have a residual value of €15,000 at the end of five years and €10,000 at the end of eight years.
7. The lessor desires a return of 12% (the implicit rate).

The first step is to calculate the annual payment due to the lessor. Recall that the present value (PV) of the minimum lease payments is equal to the selling price adjusted for the present value of the residual amount. The present value is to be computed using the implicit interest rate and the lease term. In this case, the implicit rate is given as 12% and the lease term is eight years (which includes the fixed non-cancelable portion plus the renewal period, since the lessee guarantee terms make renewal virtually inevitable). Thus, the structure of the computation would be as follows:

Normal selling price – PV of residual value = PV of minimum lease payment

Or, in this case,

$$\begin{array}{rcl}
 \text{€150,000} & - & (0.40388^* \times \text{€10,000}) & = & 4.96764^{**} \times \text{Minimum lease payment} \\
 \text{€145,961.20} & \div & 4.96764 & = & \text{Minimum lease payment} \\
 & & \text{€29,382.40} & = & \text{Minimum lease payment}
 \end{array}$$

\*0.40388 is the present value of an amount of €1 due in eight periods at a 12% interest rate.

\*\*4.96764 is the present value of an annuity of €1 for eight periods at a 12% interest rate.

Prior to examining the accounting implications of a lease, we must determine the lease classification. In this example, the lease term is eight years (discussed above) while the estimated useful life of the asset is 10 years; thus this lease qualifies as something other than an operating lease. Note that the lease also meets the FMV versus PV criterion because the PV of the minimum lease payments of €145,961.20, which is 97% of the FMV [€150,000], could be considered to be equal to substantially all of the fair value of the leased asset. Now it must be determined if this is a sales-type or direct financing lease. To do this, examine the FMV or selling price of the asset and compare it to the cost. Because the two are not equal, we can determine this to be a sales-type lease.

Next, obtain the figures necessary to record the entry on the books of the lessor. The gross investment is the total minimum lease payments plus the unguaranteed residual value, or

$$(\text{€29,382.40} \times 8) + \text{€10,000} = 245,059.20$$

The cost of goods sold is the historical cost of the inventory (€100,000) plus any initial direct costs (€2,500) less the PV of the unguaranteed residual value (€10,000 × 0.40388). Thus, the cost of goods sold amount is €98,461.20 (€100,000 + €2,500 – €4,038.80). Note that the initial direct costs will require a credit entry to some account, usually accounts payable or cash. The inventory account is credited for the carrying value of the asset, in this case €100,000.

The adjusted selling price is equal to the PV of the minimum payments, or €145,961.20. Finally, the unearned finance income is equal to the gross investment (i.e., lease receivable) less the present value of the components making up the gross investment (the minimum lease payment of €29,382.40 and the unguaranteed residual of €10,000). The present value of these items is €150,000 [(€29,382.40 × 4.96764) + (€10,000 × 0.40388)]. Therefore, the entry necessary to record the lease is:

Lease receivable	245,059.20	
Cost of goods sold	98,461.20	
Inventory		100,000.00
Sales		145,961.20
Unearned finance income		95,059.20
Accounts payable (initial direct costs)		2,500.00

The next step in accounting for a sales-type lease is to determine proper handling of the payment. Both principal and interest are included in each payment. According to IAS 17, interest is recognized on a basis such that a constant periodic rate of return is earned over the term of the lease. This will require setting up an amortization schedule as illustrated below.

<u>Date or year ended</u>	<u>Cash</u> <u>payment</u>	<u>Interest</u>	<u>Reduction</u> <u>in principal</u>	<u>Balance of</u> <u>net investment</u>
January 1, 20XX				€ 150,000.00
December 31, 20XX+1	€ 29,382.40	€18,000.00	€ 11,382.40	€ 138,617.00
December 31, 20XX+2	€ 29,382.40	€16,634.11	€ 12,748.29	€ 125,869.31
December 31, 20XX+3	€ 29,382.40	€15,104.32	€ 14,278.08	€ 111,591.23
December 31, 20XX+4	€ 29,382.40	€13,390.95	€ 15,991.45	€ 95,599.78
December 31, 20XX+5	€ 29,382.40	€11,471.97	€ 17,910.43	€ 77,689.35
December 31, 20XX+6	€ 29,382.40	€ 9,322.72	€ 20,059.68	€ 57,629.67
December 31, 20XX+7	€ 29,382.40	€ 6,915.56	€ 22,466.84	€ 35,162.83
December 31, 20XX+8	€ 29,382.40	€ 4,219.57	€ 25,162.83	€ 10,000.00
	<b>€235,059.20</b>	<b>€95,059.20</b>	<b>€140,000.00</b>	

A few of the columns need to be elaborated on. First, the net investment is the gross investment (lease receivable) less the unearned finance income. Notice that at the end of the lease term, the net investment is equal to the estimated residual value. Also note that the total interest earned over the lease term is equal to the unearned interest (unearned finance income) at the beginning of the lease term.

The entries below illustrate the proper treatment to record the receipt of the lease payment and the amortization of the unearned finance income in the year ended December 31, 20XX+1.

Cash	29,382.40	
Lease receivable		29,382.40
Unearned finance income	18,000.00	
Interest revenue		18,000.00

Notice that there is no explicit entry to recognize the principal reduction. This is done automatically when the net investment is reduced by decreasing the lease receivable (gross investment) by €29,382.40 and the unearned finance income account by only €18,000. The €18,000 is 12% (implicit rate) of the net investment. These entries are to be made over the life of the lease.

At the end of the lease term, December 31, 20XX+8, the asset is returned to the lessor and the following entry is required:

Asset	10,000	
Leased receivable		10,000

If the estimated residual value has changed during the lease term, the accounting computations would have also changed to reflect this.

### ***Direct financing leases***

Another form of finance lease is a direct financing lease. The accounting for a direct financing lease exhibits many similarities to that for a sales-type lease. Of particular importance is that the terminology used is much the same; however, the treatment accorded these items varies greatly. Again, it is best to preface the discussion by determining the objectives in the accounting for a direct financing lease. Once the lease has been classified, it must be recorded. To do this, the following amounts must be determined:

1. Gross investment.
2. Cost.
3. Residual value.

As noted, a direct financing lease generally involves a leasing company or other financial institution and results in only interest revenue being earned by the lessor. This is because the FMV (selling price) and the cost are equal, and therefore no dealer profit is recognized on the actual lease transaction. Note how this is different from a sales-type lease, which involves both a profit on the transaction and interest revenue over the lease term. The reason for this difference is derived from the conceptual nature underlying the purpose of the lease transaction. In a sales-type lease, the manufacturer (distributor, dealer, etc.) is seeking an alternative means to finance the sale of his product, whereas a direct financing lease is a result of the consumer's need to finance an equipment purchase. Because the consumer is unable to obtain conventional financing, he or she turns to a leasing company that will purchase the desired asset and then lease it to the consumer. Here the profit on the transaction remains with the manufacturer while the interest revenue is earned by the leasing company.

Like a sales-type lease, the first objective is to determine the amounts necessary to complete the following entry:

Lease receivable	xxx	
Asset		xxx
Unearned finance income		xxx

The gross investment is still defined as the minimum amount of lease payments (from the standpoint of a lessor) exclusive of any executory costs, plus the unguaranteed residual value. The difference between the gross investment as determined above and the cost (carrying value) of the asset is to be recorded as the unearned finance income because there is no manufacturer's/dealer's profit earned on the transaction. The following entry would be made to record initial direct costs:

Initial direct costs	xx	
Cash		xx

Under IAS 17, the net investment in the lease is defined as the gross investment less the unearned income plus the unamortized initial direct costs related to the lease. Initial direct

costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors. These are to be capitalized and allocated over the lease term.

Employing initial direct cost capitalization, the unearned lease (i.e., interest) income and the initial direct costs will be amortized to income over the lease term so that a constant periodic rate is earned either on the lessor's net investment outstanding or on the net cash investment outstanding in the finance lease (i.e., the balance of the cash outflows and inflows in respect of the lease, excluding any executory costs that are chargeable to the lessee). Thus, the effect of the initial direct costs is to reduce the implicit interest rate, or yield, to the lessor over the life of the lease.

An example follows that illustrates the preceding principles.

#### Example of accounting for a direct financing lease

Emirates Refining needs new equipment to expand its manufacturing operation; however, it does not have sufficient capital to purchase the asset at this time. Because of this, Emirates Refining has employed Consolidated Leasing to purchase the asset. In turn, Emirates will lease the asset from Consolidated. The following information applies to the terms of the lease:

1. A three-year lease is initiated on January 1, 20XX, for equipment costing €131,858, with an expected useful life of five years. FMV at January 1, 20XX of equipment is €131,858.
2. Three annual payments are due to the lessor beginning December 31, 20XX. The property reverts back to the lessor on termination of the lease.
3. The unguaranteed residual value at the end of year three is estimated to be €10,000.
4. The annual payments are calculated to give the lessor a 10% return (the implicit rate).
5. The lease payments and unguaranteed residual value have a PV equal to €131,858 (FMV of asset) at the stipulated discount rate.
6. The annual payment to the lessor is computed as follows:

$$\begin{aligned}
 \text{PV of residual value} &= €10,000 \times .7513^* = €7,513 \\
 \text{PV of lease payments} &= \text{Selling price} - \text{PV of residual value} \\
 &= €131,858 - €7,513 = €124,345 \\
 \text{Annual payment} &= €124,345 \div 2.4869^{**} = €50,000
 \end{aligned}$$

\*7513 is the PV of an amount due in three periods at 10%.

\*\*2.4869 is the PV of an ordinary annuity of €1 per period for three periods, at 10% interest.

7. Initial direct costs of €7,500 are incurred by ABC in the lease transaction.

As with any lease transaction, the first step must be to classify the lease appropriately. In this case, the PV of the lease payments (€124,345) is equal to 94% of the FMV (€131,858), thus could be considered as equal to substantially all of the FMV of the leased asset. Next, the unearned interest and the net investment in lease are to be determined.

Gross investment in lease [(3 × €50,000) + €10,000]	€160,000
Cost of leased property	€131,858
Unearned finance income	€ <u>28,142</u>

The unamortized initial direct costs are to be added to the gross investment in the lease, and the unearned finance income is to be deducted to arrive at the net investment in the lease. The net investment in the lease for this example is determined as follows:

Gross investment in lease	€160,000
Add:	
Unamortized initial direct costs	€ <u>7,500</u>
Less:	
Unearned finance income	€ <u>28,142</u>
Net investment in lease	<u><u>€139,358</u></u>

The net investment in the lease (Gross investment – Unearned finance income) has been increased by the amount of initial direct costs. Therefore, the implicit rate is no longer 10%, and the implicit rate must be recomputed, which is the result of performing an internal rate of return calculation. The lease payments are to be €50,000 per annum and a residual value of €10,000 is available at the end of the lease term. In return for these payments (inflows), the lessor is giving up equipment (an outflow) and incurring initial direct costs (also an outflow), with a net investment of €139,358 (€131,858 + €7,500). The way to obtain the new implicit rate is to employ a calculator or computer routine that does this iterative computation automatically.

$$\frac{50,000}{(1+i)} + \frac{50,000}{(1+i)^2} + \frac{50,000}{(1+i)^3} + \frac{10,000}{(1+i)^3} = €139,358$$

Where:  $i$  = implicit rate of interest

In this case, the implicit rate is equal to 7.008%. Thus, the amortization table would be set up as follows:

	(a) <i>Lease payments</i>	(b) <i>Reduction in unearned Interest</i>	(c) <i>PV × Implicit rate (7.008%)</i>	(d) <i>Reduction in initial direct costs (b-c)</i>	(e) <i>Reduction in PVI net investment (a-b + d)</i>	(f) <i>PVI net investment in lease (f)(n+1) = (f)n - (e)</i>
At inception						€139,358
20XX	€ 50,000	€13,186 (1)	€ 9,766	€3,420	€ 40,234	€99,124
20XX+1	€50,000	€9,504 (2)	€6,947	€2,557	€43,053	€56,071
20XX+2	€ <u>50,000</u>	€ <u>5,455 (3)</u>	€ <u>3,929</u>	€ <u>1,526</u>	€ <u>46,071</u>	€10,000
	<u>€150,000</u>	€ <u>28,145*</u>	€ <u>20,642</u>	€ <u>7,503</u>	€ <u>129,358</u>	

\* Rounded

(b.1) €131,858 × 10% = €13,186

(b.2) [€131,858 – (€50,000 – 13,186)] × 10% = €9,504

(b.3) [€95,044 – (€50,000 – 9,504)] × 10% = €5,455

Here the interest is computed as 7.008% of the net investment. Note again that the net investment at the end of the lease term is equal to the estimated residual value.

The entry made initially to record the lease is as follows:

Lease receivable** [(€50,000 × 3) + €10,000]	160,000	
Asset acquired for leasing		131,858
Unearned lease revenue	28,142	

When the payment (or obligation to pay) of the initial direct costs occurs, the following entry must be made:

Initial direct costs	7,500	
Cash		7,500

Using the schedule above, the following entries would be made during each of the indicated years:

	<u>20XX</u>		<u>20XX+1</u>		<u>20XX+2</u>
Cash	50,000		50,000		50,000
Lease receivable**		50,000		50,000	50,000
Unearned finance income	13,186		9,504		5,455
Initial direct costs		3,420		2,557	1,526
Interest income		9,766		6,947	3,929

Finally, when the asset is returned to the lessor at the end of the lease term, it must be recorded on the books. The necessary entry is as follows:

Property, plant & equipment		10,000	
Lease receivable**			10,000

\*\* Also commonly referred to as the “gross investment in lease.”

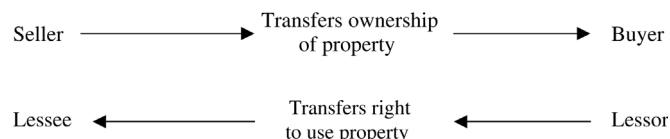
### Leveraged leases

Leveraged leases are discussed in detail in Appendix B of this chapter because of the complexity involved in the accounting treatment based on guidance available under US GAAP, where this topic has been given extensive coverage. Under IFRS, this concept has been defined, but with only a very brief outline of the treatment to be accorded to this kind of lease. A leveraged lease is defined as a finance lease which is structured such that there are at least three parties involved: the lessee, the lessor and one or more long-term creditors who provide part of the acquisition finance for the leased asset, usually without any general recourse to the lessor. Succinctly, this type of a lease is given the following unique accounting treatment:

1. The lessor records his or her investment in the lease net of the non-recourse debt and the related finance costs to the third-party creditor(s).
2. The recognition of the finance income is based on the lessor’s net cash investment outstanding in respect of the lease.

### Sale-Leaseback Transactions

Sale-leaseback describes a transaction where the owner of property (the seller-lessee) sells the property and then immediately leases all or part of it back from the new owner (the buyer-lessor). These transactions may occur when the seller-lessee is experiencing cash flow or financing problems or because there are tax advantages in such an arrangement in the lessee’s tax jurisdiction. The important consideration in this type of transaction is recognition of two separate and distinct economic transactions. However, it is important to note that there is not a physical transfer of property. First, there is a sale of property, and second, there is a lease agreement for the same property in which the original seller is the lessee and the original buyer is the lessor. This is illustrated as follows:



A sale-leaseback transaction is usually structured such that the sales price of the asset is greater than or equal to the current market value. The higher sales price has the concomitant effect of a higher periodic rental payment over the lease term than would otherwise have been negotiated. The transaction is usually attractive because of the tax benefits associated with it, and because it provides financing to the lessee. The seller-lessee benefits from the higher price because of the increased gain on the sale of the property and the deductibility of the lease payments, which are usually larger than the depreciation that was previously being taken. The buyer-lessor benefits from both the higher rental payments and the larger depreciable basis.

Under IAS 17, the accounting treatment depends on whether the leaseback results in a finance lease or an operating lease. If it results in a finance lease, any excess of sale proceeds over previous carrying value may not be recognized immediately as income in the financial statements of the seller-lessee. Rather, it is to be deferred and amortized over the lease term.

Accounting for a sale-leaseback that involves the creation of an operating lease depends on whether the sale portion of the compound transaction was on arm's-length terms. If the leaseback results in an operating lease, and it is evident that the transaction is established at fair value, then any profit or loss should be recognized immediately. On the other hand, if the sale price is *not* established at fair value, then:

1. If sale price is *below* fair value, any profit or loss should be recognized immediately, except that when a loss is to be compensated by below fair market future rentals, the loss should be deferred and amortized in proportion to the rental payments over the period the asset is expected to be used.
2. If the sale price is *above* fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

IAS 17 stipulates that, in case of operating leasebacks, if at the date of the sale and leaseback transaction the fair value is less than the carrying amount of the leased asset, the difference between the fair value and the carrying amount should immediately be recognized. In other words, impairment is recognized first, before the actual sale-leaseback transaction is given recognition. This logically follows from the fact that impairments are essentially catch-up depreciation charges, belated recognition that the consumption of the utility of the assets had not been correctly recognized in earlier periods.

However, in case the sale and leaseback result in a finance lease, no such adjustment is considered necessary unless there has been an impairment in value, in which case the carrying value should be reduced to the recoverable amount in accordance with the provisions of IAS 36.

The guidance under IFRS pertaining to sale-leaseback transactions is limited, and many variations in terms and conditions are found in actual practice. To provide further insight, albeit not with the suggestion that this constitutes IFRS, selected guidance found under US GAAP is offered in Appendix A to this chapter.

### ***Other leasing guidance***

SIC 27 addresses arrangements between an enterprise and an investor that involve the legal form of a lease. SIC 27 establishes that the accounting for such arrangements is in all instances to reflect the substance of the relationship. All aspects of the arrangement are to be evaluated to determine its substance, with particular emphasis on those that have an economic effect. To assist in doing this, SIC 27 identifies certain indicators that may demonstrate that an arrangement might not involve a lease under IAS 17. For example, a series of linked transactions that in substance do not transfer control over the asset, and

which keep the right to receive the benefits of ownership with the transferor, would not be a lease. Also, transactions arranged for specific objectives, such as the transfer of tax attributes, would generally not be accounted for as leases.

SIC 27 deals most specifically with those arrangements that have characteristics of leases coupled with corollary subleases, whereby the lessor is the sublessee and the lessee is the sublessor, which may also involve a purchase option. The financing party (the lessee-sublessor) is often guaranteed a certain economic return on such transactions, further revealing that the substance might in fact be that of a secured borrowing rather than a series of lease arrangements. Since nominal lease and sublease payments will net to zero, the exchange of funds is often limited to the fee given by the property owner to the party providing financing; tax advantages are often the principal objective of these transactions. Accounting questions arising from the transactions include recognition of fees received by the financing party; the presentation of separate investment and sublease payment obligation accounts as an asset and a liability, respectively; and the accounting for resulting obligations.

SIC 27 imposes a substance over form solution to this problem. Accordingly, when an arrangement is found to not meet the definition of a lease, a separate investment account and a lease payment obligation would not meet the definitions of an asset and a liability, and should not be recognized by the entity. It presents certain indicators which imply that a given arrangement is not a lease (e.g., when the right to use the property for a given term is not in fact transferred to the nominal lessee) and that lease accounting cannot be applied.

The interpretation provides that the fee paid to the financing provider should be recognized in accordance with IAS 18. Fees received in advance would generally be deferred and recognized over the lease term when future performance is required in order to retain the fee, when limitations are placed on the use of the underlying asset, or when the non-remote likelihood of early termination would necessitate some fee repayment.

Finally, SIC 27 identifies certain factors that would suggest that other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, should be accounted for under either IAS 37 (contingent liabilities) or IAS 39 (financial obligations), depending on the terms.

IFRIC 4 describes arrangements, comprising transactions or series of related transactions, that do not take the legal form of a lease, but which convey rights to use assets in return for series of payments. Examples of such arrangements include:

- Outsourcing arrangements (e.g., the outsourcing of the data processing functions of an entity).
- Various arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide other entities with rights to capacity.
- “Take-or-pay” and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (these are often styled as capacity contracts, giving one party exclusive rights to the counterparty’s output).

IFRIC 4 provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with IAS 17. It does not address how such arrangements, if determined to be leases, should be classified. In some of these arrangements, the underlying asset that is the subject of the lease is a portion of a larger asset. IFRIC 4 does not address how to ascertain if the portion of a larger asset is itself the underlying asset for the purposes of applying IAS 17. However, arrangements in which the underlying asset would



represent a unit of account under either IAS 16 or IAS 38 are within the scope of this interpretation. Leases which would be excluded from IAS 17 (as noted earlier in this chapter) are not subject to the provisions of IFRIC 4.

Determining whether an arrangement is, or contains, a lease is required to be based on the substance of the arrangement. It requires an assessment of whether:

1. Fulfillment of the arrangement is dependent on the use of a specific asset or assets; *and*
2. The arrangement conveys a right to use the asset.

An arrangement is not the subject of a lease if its fulfillment is not dependent on the use of the specified asset. Thus, if terms call for delivery of a specified quantity of goods or services, and the entity has the right and ability to provide those goods or services using other assets not specified in the arrangement, it is not subject to this interpretation. On the other hand, a warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly, or a contractual provision (whether or not contingent) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date, do not preclude lease treatment before the date of substitution.

IFRIC 4 states that an asset has been *implicitly specified* if, for example, the supplier owns or leases only one asset with which to fulfill the obligation, and it is not economically feasible to perform its obligation through the use of alternative assets.

An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (putatively, the lessee) the right to control the use of the underlying asset. This occurs if:

1. The purchaser has the ability or right to operate the asset (or direct others to operate the asset) in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other value of the asset;
2. The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset; or
3. Facts and circumstances suggest that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output of the asset, or other value that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

According to IFRIC 4, the assessment of whether an arrangement contains a lease is to be made at the inception of the arrangement. This is defined as the earlier of the date of the arrangement or the date the parties commit to the principal terms of the arrangement, on the basis of all of the facts and circumstances. Once determined, a reassessment is permitted only if:

1. There is a change in the contractual terms, unless the change only renews or extends the arrangement;
2. A renewal option is exercised or an extension is agreed to by the parties, unless the term of the renewal or extension had initially been included in the lease term in accordance with IAS 17 (a renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement is to be evaluated only with respect to the renewal or extension period);

3. There is a change in the determination of whether fulfillment is dependent on a specified asset; or
4. There is a substantial change to the asset (e.g., a substantial physical change to property, plant or equipment).

Any reassessment of an arrangement is to be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Changes in estimate (e.g., as to the expected output to be delivered) may not be used to trigger a reassessment. If the reassessment concludes that the arrangement contains (or does not contain) a lease, lease accounting is to be applied (or cease to be applied) from when the change in circumstances giving rise to the reassessment occurs (if other than exercise of a renewal or extension), or the inception of the renewal or extension period.

If an arrangement is determined to contain a lease, both parties are to apply the requirements of IAS 17 to the lease element of the arrangement. Accordingly, the lease must be classified as a finance lease or an operating lease. Other elements of the arrangement, not within the scope of that standard, are to be accounted for as required by the relevant IFRS. For the purpose of applying IAS 17, payments and other consideration required must be separated, at inception or upon a reassessment of the arrangement, into that being made for the lease and that applicable to the other elements, on the basis of relative fair values. Minimum lease payments (per IAS 17) include only payments for the lease itself.

In some instances it will be necessary to make assumptions and estimates in order to separate the payments for the lease from payments for the other elements. IFRIC 4 suggests that a purchaser might estimate the lease payment portion by reference to a lease for a comparable asset that contains no other elements, or might estimate the payments for the other elements by reference to comparable agreements, deriving the payments for the other component by deduction. However, if a purchaser concludes that it is impracticable to separate the payments reliably, the procedure to be followed depends on whether the lease is operating or finance in nature.

If a finance lease, the purchaser/lessee is to recognize an asset and a liability at an amount equal to the fair value of the underlying asset that was identified as being the subject of the lease. As payments are later made, the liability will be reduced and an imputed finance charge on the liability will be recognized using the purchaser's incremental borrowing rate of interest (as described earlier in this chapter).

If an operating lease, the purchaser/lessee is to treat all payments as lease payments for the purposes of complying with the disclosure requirements of IAS 17, but (1) disclose those payments separately from minimum lease payments of other arrangements that do not include payments for non-lease elements, and (2) state that the disclosed payments also include payments for non-lease elements in the arrangement.

## **DISCLOSURE REQUIREMENTS UNDER IAS 17**

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### **Lessee Disclosures**

#### **1. Finance Leases**

IAS 17 mandates the following disclosures for lessees under finance leases, in addition to disclosures required under IFRS 7 for all financial instruments:

- a. For each class of asset, the net carrying amount at the end of the reporting period (the date of the statement of financial position).

- b. A reconciliation between the total of minimum lease payments at the end of the reporting period, and their present value. In addition, an enterprise should disclose the total of the minimum lease payments at the end of the reporting period, their present value, for each of the following periods:
  - 1. Due in one year or less.
  - 2. Due in more than one but no more than five years.
  - 3. Due in more than five years.
- c. Contingent rents included in profit or loss for the period.
- d. The total of minimum sublease payments to be received in the future under non-cancelable subleases at the end of the reporting period.
- e. A general description of the lessee's significant leasing arrangements including, but not necessarily limited to the following:
  - 1. The basis for determining contingent rentals.
  - 2. The existence and terms of renewal or purchase options and escalation clauses.
  - 3. Restrictions imposed by lease arrangements such as on dividends or assumptions of further debt or further leasing.

## 2. Operating Leases

IAS 17 sets forth in greater detail the disclosure requirements that will be applicable to lessees under operating leases.

Lessees should, in addition to the requirements of IFRS 7, make the following disclosures for operating leases:

- a. Total of the future minimum lease payments under non-cancelable operating leases for each of the following periods:
  - 1. Due in one year or less.
  - 2. Due in more than one year but no more than five years.
  - 3. Due in more than five years.
- b. The total of future minimum sublease payments expected to be received under non-cancelable subleases at the end of the reporting period.
- c. Lease and sublease payments included in profit or loss for the period, with separate amounts of minimum lease payments, contingent rents and sublease payments.
- d. A general description of the lessee's significant leasing arrangements including, but not necessarily limited to the following:
  - 1. The basis for determining contingent rentals.
  - 2. The existence and terms of renewal or purchase options escalation clauses.
  - 3. Restrictions imposed by lease arrangements such as on dividends or assumption of further debt or on further leasing.

## Lessor Disclosures

### 1. Finance Leases

IAS 17 requires enhanced disclosures compared to the original standard. Lessors under finance leases are required to disclose, in addition to disclosures under IFRS 7, the following:

- a. A reconciliation between the total gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period, categorized into:
  1. Those due in one year or less.
  2. Those due in more than one year but not more than five years.
  3. Those due beyond five years.
- b. Unearned finance income.
- c. The unguaranteed residual values accruing to the benefit of the lessor.
- d. The accumulated allowance for uncollectible minimum lease payments receivable.
- e. Total contingent rentals included in income.
- f. A general description of the lessor's significant leasing arrangements.

## 2. Operating Leases

For lessors under operating leases, IAS 17 has prescribed the following expanded disclosures:

- a. The future minimum lease payments under non-cancellable operating leases, in the aggregate and classified into:
  1. Those due in no more than one year.
  2. Those due in more than one but not more than five years.
  3. Those due in more than five years.
- b. Total contingent rentals included in profit or loss for the period.
- c. A general description of leasing arrangements to which it is a party.

In addition to the above, the disclosure requirements relating to the assets recognized by the lessor or lessee required in the respective standards governing the accounting for those assets should be given. These include IAS 16, IAS 38, IAS 40 and IAS 41. These disclosure requirements are detailed in the respective chapters looking at each of these sections.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

### 2. Accounting policies

#### 2.13 Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases. IAS17 p33

##### 2.13.1 As Lessor

#### Operating leases

IAS17 p20

Rental income from operating leases is recognized on a straight-line basis over the term of the relevant lease. Any balloon payments and rent free periods are taken into account when determining the straight-line charge.

**2.13.2 As Lessee**

IAS17 p27

**Finance leases**

Assets held under finance leases are recognized as assets of the Group at the fair value at the inception of the lease or if lower, at the present value of the minimum lease payments. The related liability to the lessor is included in the statement of financial position as a finance lease obligation.

Lease payments are apportioned between interest expenses and capital redemption of the liability, Interest is recognized immediately in profit or loss, unless attributable to qualifying assets, in which case they are capitalized to the cost of those assets.

Contingent rentals are recognized as expenses in the periods in which they are incurred.

**Operating leases**

Operating lease payments are recognized as an expense on a straight-line basis over the lease term, except if another systematic basis is more representative of the time pattern in which economic benefits will flow to the Group.

Contingent rentals arising under operating leases are recognized in the period in which they are incurred.

Lease incentives and similar arrangements of incentives are taken into account when calculating the straight-lined expense.

**3.2 Critical judgements in applying the group’s accounting policies**

**Retail stores refurbishment**

IAS1 p122

The group has recognized a provision for store refurbishment in the statement of financial position as at 31 December 20XX. As management were considered to be fully committed to the expenditure and the group has obligations in terms of its lease agreements to affect the refurbishments, they believe that the appropriate accounting treatment is to make a provision in the statement of financial position as at 31 December 20XX.

**Operating lease commitments**

IAS1 p122

The group has entered into property leases over a number of retail stores. As management have determined that the group has not obtained substantially all the risks and rewards of ownership of these properties, the leases have been classified as operating leases and accounted for accordingly.

**6. Disclosure of expenses**

	20XX	20XX-1	
The following amounts were expensed or credited during the year:			
Operating lease expense	X	X	IAS17 p35(c)

**15. Property, Plant and Equipment**

.....  
 ..... (continued)

Plant and machinery includes the following amounts where the group is a lessee under a finance lease: IAS 17 p31(a)

	20XX	20XX-1
Cost - capitalized finance leases	X	X
Accumulated depreciation	X	X
Net book value	X	X

## 24. Notes to the statement of cash flows

### 24.1 Significant non-cash transactions

During the period the group acquired property, plant and equipment with a total cost of £ X of which £ Y was acquired by means of finance leases. IAS7 p43

### 27. Finance lease liabilities

	20XX	20XX-1
Gross finance lease liabilities - minimum lease payments:		
Within 1 year	X	X
Later than 1 year and no later than 5 years	X	X
Later than 5 years	X	X
	X	X
Future finance chargers on finance leases	X	X
Present value of finance lease liabilities	X	X

The present value of finance lease liabilities is analysed as follows: IAS17 p31(b)

Within 1 year	X	X
Later than 1 year and no later than 5 years	X	X
Later than 5 years	X	X
	X	X

Lease liabilities are secured over property, plant and equipment as disclosed in note 15. These assets will revert back to the lessor in the event of a default. IAS17 p31(e)

The company leases certain items of property, plant and equipment under lease agreements with a 5 year term. These bear interest at between 2% and 4,5% and are repayable in equal monthly instalments

### 33. Operating lease commitments

#### As a lessee:

It is group policy to rent certain items of office equipment and premises under operating lease agreements. The lease terms of these agreements vary between 3 and 10 years. No contingent rent is payable.

	20XX	20XX-1	IAS17 p35
As a lessee:			
Future minimum lease payments under non-cancellable operating leases:			
Within one year	X	X	
From one to five years	X	X	
After five years	X	X	
	X	X	

The group does not sub-lease any of its leased premises.

Lease payments recognized in profit for the period amounted to £ X (20XX-1: £ X).

**As a lessor:**

The company leases its Investment Property to various third parties under operating lease agreements. The average lease term was ten years, with annual escalation set at 2%.

	20XX	20XX-1	IAS17 p56
Future minimum lease receipts under non-cancellable operating leases:			
Within one year	X	X	
From one to five years	X	X	
After five years	X	X	
	X	X	

No contingent rentals were recognized in income.

## **FUTURE DEVELOPMENTS**

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Because of the significance of this area of practice in all economies, and the remaining divergence of requirements under alternative sets of standards, the IASB and the FASB have undertaken a project to reconsider lease accounting. In March 2009, the IASB published a Discussion Paper proposing changes to lease accounting. This was followed up by an Exposure Draft in August 2010 and a second Exposure Draft in May 2013. The aim of the project is to develop a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognized in the statement of financial position. This would do away with the arbitrary distinction between finance and operating leases under the current IAS 17, and replace it with the recognition of a lease liability and the right to use an asset.

Some of the key issues in the exposure draft addressed are as follows:

- Lessees would recognize assets and liabilities for all leases of more than 12 months—operating leases that currently exist under IAS 17 would cease to exist.
- Both the asset and the liability are initially measured at the present value of lease payments. The right-of-use asset also includes any direct costs.
- Excluding most variable payments and payments in optional periods from the measurement of lease assets and liabilities.
- Proposes a dual approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease depending on whether the entity consumes the asset (such as equipment lease) or merely pays for the usage (such as property leases).
- An entity would classify a lease largely on the basis of the nature of the underlying asset, i.e., most leases of equipment or vehicles would be classified as Type A leases and most leases of property would be classified as Type B leases.
- A lessee will recognize interest and depreciation in the income statement for Type A leases, but only one rental income for Type B leases.

- A lessor of most equipment would recognize a lease receivable and a retained interest in the underlying asset (the residual asset), and derecognize the underlying asset; and recognize interest income on both the lease receivable and the residual asset over the lease term.
- A lessor of most property leases will continue to recognize the underlying asset and recognize rental income.

The comment period for the second Exposure Draft closed on September 13, 2013 and the boards are currently reviewing these comments as part of their redeliberation process. There have been some tentative decisions made but the leasing project is still under discussion and these decisions are subject to any further discussion. Some of the tentative decisions made by the IASB to date include:

- There would be a single approach for lessee accounting. Lessees would recognize assets and liabilities for all leases of more than 12 months—operating leases that currently exist under IAS 17 would cease to exist.
- Lessor accounting will remain essentially unchanged to how it is currently accounted for under IAS 17.

## US GAAP COMPARISON

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US GAAP accounting and criteria for leases is very similar. See Appendix A attached to this chapter for specific US interpretations. However, US GAAP uses quantitative criteria to classify a lease as either operating or capital. IFRS is based on the substance of the transaction to assess whether a substantial amount of the value or useful life of the asset is conveyed to the lessee.

Third-party guarantees are not included in the minimum lease payments (nor measurement of the obligation and asset). Leases of land and buildings are accounted for together unless land is greater than 25% of the property value.

US GAAP does not contain the direct guidance about identifying an embedded derivative in the lease if the lessee has a stake in the market value of the asset.

The IASB and the FASB have a joint project on leases – see Future Developments earlier in this chapter.



## **APPENDIX A: SPECIAL SITUATIONS NOT ADDRESSED BY IAS 17 BUT WHICH HAVE BEEN INTERPRETED UNDER US GAAP**

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In the following section, a number of interesting and common problem areas that have not yet been addressed by IFRS are briefly considered. The guidance found in US GAAP is referenced, as this is likely to represent the most comprehensive source of insight into these matters. However, it should be understood that this constitutes only *possible* approaches to selected fact situations, and is not authoritative guidance. Some of these matters may be more fully addressed by IFRS if the proposed amendments to IAS 17 are brought to fruition.

### **Sale-Leaseback Transactions**

The accounting treatment from the seller-lessee's perspective will depend on the degree of rights to use retained by the seller-lessee. The degree of rights to use retained may be categorized as follows:

1. Substantially all.
2. Minor.
3. More than minor but less than substantially all.

The guideline for the determination substantially all is based on the classification criteria presented for the lease transaction. For example, a test based on the 90% recovery criterion seems appropriate. That is, if the present value of fair rental payments is equal to 90% or more of the fair value of the sold asset, the seller-lessee is presumed to have retained substantially all the rights to use the sold property. The test for retaining minor rights would be to substitute 10% or less for 90% or more in the preceding sentence.

If substantially all the rights to use the property are retained by the seller-lessee and the agreement meets at least one of the criteria for capital lease treatment, the seller-lessee should account for the leaseback as a capital lease, and any profit on the sale should be deferred and either amortized over the life of the property or treated as a reduction of depreciation expense. If the leaseback is classified as an operating lease, it should be accounted for as one, and any profit or loss on the sale should be deferred and amortized over the lease term. Any loss on the sale would also be deferred unless the loss were perceived to be a real economic loss, in which case the loss would be recognized immediately and not deferred.

If only a minor portion of the rights to use are retained by the seller-lessee, the sale and the leaseback should be accounted for separately. However, if the rental payments appear unreasonable based on the existing market conditions at the inception of the lease, the profit or loss should be adjusted so that the rentals are at a reasonable amount. The amount created by the adjustment should be deferred and amortized over the life of the property if a capital lease is involved or over the lease term if an operating lease is involved.

If the seller-lessee retains more than a minor portion but less than substantially all the rights to use the property, any excess profit on the sale should be recognized on the date of the sale. For purposes of this paragraph, excess profit is derived as follows:

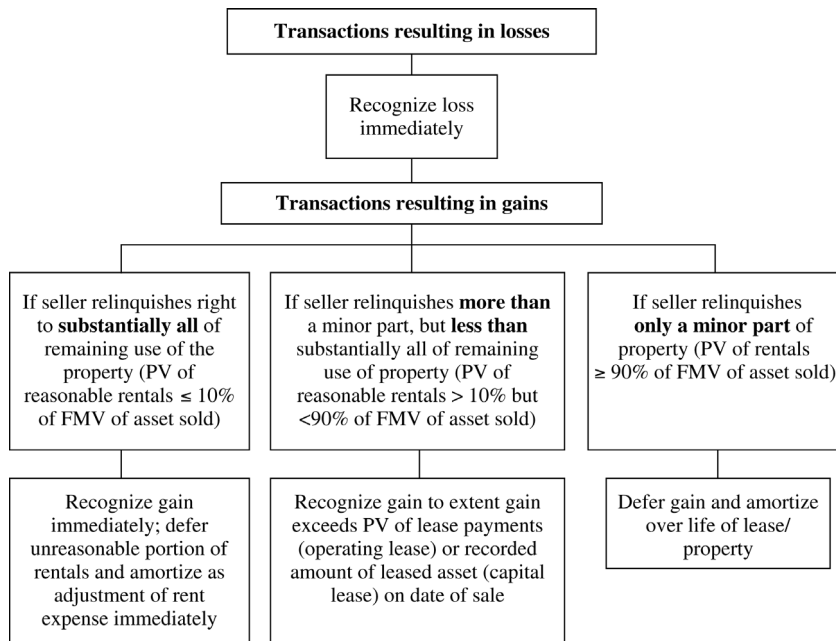
1. If the leaseback is classified as an operating lease, the excess profit is the profit that exceeds the present value of the minimum lease payments over the lease term. The seller-lessee should use its incremental borrowing rate to compute the present value of the minimum lease payments. If the implicit rate of interest in the lease is known, it should be used to compute the present value of the minimum lease payments.

2. If the leaseback is classified as a capital (i.e., finance) lease, the excess profit is the amount greater than the recorded amount of the leased asset.

When the fair value of the property at the time of the leaseback is less than its undepreciated cost, the seller-lessee should immediately recognize a loss for the difference. In the example below, the sales price is less than the book value of the property. However, there is no economic loss because the FMV is greater than the book value.

Sales price \$85,000	Book value \$90,000	FMV and PVz \$100,000
<div style="border: 1px solid black; width: 100%; height: 20px; margin: 0 auto;"></div> <p style="margin: 0 auto;">(\$5,000)</p>		
Artificial loss		

The artificial loss must be deferred and amortized as an addition to depreciation. The following diagram summarizes the accounting for sale-leaseback transactions.



In the foregoing circumstances, when the leased asset is land only, any amortization should be on a straight-line basis over the lease term, regardless of whether the lease is classified as a capital or an operating lease.

Executory costs are not to be included in the calculation of profit to be deferred in a sale-leaseback transaction. The buyer-lessor should account for the transaction as a purchase and a direct financing lease if the agreement meets the criteria of *either* a direct financing lease **or** a sales-type lease. Otherwise, the agreement should be accounted for as a purchase and an operating lease.

### ***Sale-leaseback involving real estate***

Under US GAAP, three requirements are necessary for a sale-leaseback involving real estate (including real estate with equipment) to qualify for sale-leaseback accounting

treatment. Those sale-leaseback transactions not meeting the three requirements should be accounted for as a deposit or as a financing. The three requirements are:

1. The lease must be a normal leaseback.
2. Payment terms and provisions must adequately demonstrate the buyer-lessor's initial and continuing investment in the property.
3. Payment terms and provisions must transfer all the risks and rewards of ownership as demonstrated by a lack of continuing involvement by the seller-lessee.

A normal leaseback involves active use of the leased property in the seller-lessee's trade or business during the lease term.

The buyer-lessor's initial investment is adequate if it demonstrates the buyer-lessor's commitment to pay for the property and indicates a reasonable likelihood that the seller-lessee will collect any receivable related to the leased property. The buyer-lessor's continuing investment is adequate if the buyer is contractually obligated to pay an annual amount at least equal to the level of annual payment needed to pay that debt and interest over no more than (1) 20 years for land, and (2) the customary term of a first mortgage loan for other real estate.

Any continuing involvement by the seller-lessee other than normal leaseback disqualifies the lease from sale-leaseback accounting treatment. Some examples of continuing involvement other than normal leaseback include:

1. The seller-lessee has an obligation or option (excluding the right of first refusal) to repurchase the property.
2. The seller-lessee (or party related to the seller-lessee) guarantees the buyer-lessor's investment or debt related to that investment or a return on that investment.
3. The seller-lessee is required to reimburse the buyer-lessor for a decline in the fair value of the property below estimated residual value at the end of the lease term based on other than excess wear and tear.
4. The seller-lessee remains liable for an existing debt related to the property.
5. The seller-lessee's rental payments are contingent on some predetermined level of future operations of the buyer-lessor.
6. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback.
7. The seller-lessee provides non-recourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is the leased asset.
8. The seller-lessee enters into a sale-leaseback involving property improvements or integral equipment without leasing the underlying land to the buyer-lessor.
9. The buyer-lessor is obligated to share any portion of the appreciation of the property with the seller-lessee.
10. Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or appreciation of the leased property.

#### **Example of accounting for a sale-leaseback transaction**

To illustrate the accounting treatment in a sale-leaseback transaction, suppose that Lessee Corporation sells equipment that has a book value of €80,000 and a fair value of

€100,000 to Lessor Corporation, and then immediately leases it back under the following conditions:

1. The sale date is January 1, 20XX, and the equipment has a fair value of €100,000 on that date and an estimated useful life of 15 years.
2. The lease term is 15 years, non-cancellable, and requires equal rental payments of €13,109 at the beginning of each year.
3. Lessee Corp. has the option annually to renew the lease at the same rental payments on expiration of the original lease.
4. Lessee Corp. has the obligation to pay all executory costs.
5. The annual rental payments provide the lessor with a 12% return on investment.
6. The incremental borrowing rate of Lessee Corp. is 12%.
7. Lessee Corp. depreciates similar equipment on a straight-line basis.

Lessee Corp. should classify the agreement as a capital lease since the lease term exceeds 75% (which is deemed to be a major part) of the estimated economic life of the equipment, and because the present value of the lease payments is greater than 90% (deemed to be substantially all) of the fair value of the equipment. Assuming that collectibility of the lease payments is reasonably predictable and that no important uncertainties exist concerning the amount of non-reimbursable costs yet to be incurred by the lessor, Lessor Corp. should classify the transaction as a direct financing lease because the present value of the minimum lease payments is equal to the fair market value of €100,000 ( $€13,109 \times 7.62817$ ).

Lessee Corp. and Lessor Corp. would normally make the following journal entries during the first year:

#### Upon Sale of Equipment on January 1, 20XX

	<u>Lessee Corp.</u>		<u>Lessor Corp.</u>	
Cash	100,000		Equipment	100,000
Equipment*	80,000	Cash		100,000
Unearned profit on sale-leaseback	20,000			
Leased equipment	100,000	Lease receivable		
Lease obligations	100,000	(€13,109 × 15)	196,635	
		Equipment		100,000
		Unearned interest		96,635

\*Assumes new equipment.

#### To Record First Payment on January 1, 20XX

	<u>Lessee Corp.</u>		<u>Lessor Corp.</u>	
Lease obligations	13,109		Cash	13,109
Cash	13,109	Lease receivable		13,109

#### To Record Incurrence and Payment of Executory Costs

	<u>Lessee Corp.</u>		<u>Lessor Corp.</u>	
Insurance, taxes, etc.	xxx		(No entry)	
Cash (accounts payable)	xxx			

#### To Record Depreciation Expense on the Equipment, December 31, 20XX

	<u>Lessee Corp.</u>		<u>Lessor Corp.</u>	
Depreciation expense	6,667		(No entry)	
Accum. depr.— capital leases (€100,000 ÷ 15)	6,667			

**To Amortize Profit on Sale-Leaseback by Lessee Corp., December 31, 20XX**

	<u>Lessee Corp.</u>	<u>Lessor Corp.</u>
Unearned profit on sale-leaseback	1,333	(No entry)
Depr. expense (€20,000 ÷ 15)		1,333

**To Record Interest for December 31, 20XX**

	<u>Lessee Corp.</u>		<u>Lessor Corp.</u>	
Interest expense	10,427	Unearned interest income	10,427	
Accrued interest payable		10,427	Interest income	10,427

**Partial Lease Amortization Schedule**

<u>Date</u>	<u>Cash payment</u>	<u>Interest expense</u>	<u>Reduction of obligation</u>	<u>Lease obligation</u>
Inception of lease			€100,000	
January 1, 20XX	€13,109	€ –	€13,109	€86,891
January 1, 20XX+1	€13,109	€10,427	€ 2,682	€84,209

**Leases Involving Real Estate—Guidance under US GAAP**

While required practice regarding lease accounting is rather clearly set forth under IAS 17, as is typical under IFRS this is presented in rather general terms. US GAAP, by contrast, offers a great deal of very specific guidance on this topic. It is instructive to at least consider the US GAAP rules for lease accounting, which may provide some further insight and, in some circumstances, offer operational guidance to those attempting to apply IAS 17 to particular fact situations. Under US GAAP (which consists of many discrete standards and a large volume of interpretive literature), leases involving real estate are categorized into four groups:

1. Leases involving land only.
2. Leases involving land and building(s).
3. Leases involving real estate and equipment.
4. Leases involving only part of a building.

**Leases Involving Land Only**

**Lessee accounting.** If the lease agreement meets the criteria for transfers of ownership or contains a bargain purchase option, the lessee should account for the lease as a capital lease and record an asset and related liability in an amount equal to the present value of the minimum lease payments after deducting executor costs. If the lease agreement does not transfer ownership or contain a bargain purchase option, the lessee should account for the lease as an operating lease.

**Lessor accounting.** If the lease gives rise to dealer's profit (or loss) and transfers ownership (i.e., title), the standards require that the lease shall be classified as a sales-type lease and accounted for under the provisions of the US standard dealing with sales of real estate, in the same manner as would a seller of the same property. If the lease transfers ownership, both the collectibility and the no material uncertainties criteria are met, but if it does not give rise to dealer's profit (or loss), the lease should be accounted for as a direct financing or leveraged lease, as appropriate. If the lease contains a bargain purchase option and both the collectibility and no material uncertainties criteria are met, the lease should be

accounted for as a direct financing, leveraged, or operating lease as appropriate. If the lease does not meet the collectibility and/or no material uncertainties criteria, the lease should be accounted for as an operating lease.

### Leases Involving Land and Building

**Lessee accounting.** Under US GAAP, if the agreement meets the transfer of ownership criteria or contains a bargain purchase option, the lessee should account for the agreement by separating the land and building components and capitalize each separately. The land and building elements should be allocated on the basis of their relative fair market values measured at the inception of the lease. The land and building components are accounted for separately because the lessee is expected to own the real estate by the end of the lease term. The building should be depreciated over its estimated useful life without regard to the lease term.

When the lease agreement neither transfers title nor contains a bargain purchase option, the fair value of the land must be determined in relation to the fair value of the aggregate properties included in the lease agreement. If the fair value of the land is less than 25% of the fair value of the leased properties in aggregate, the land is considered immaterial. Conversely, if the fair value of the land is 25% or greater of the fair value of the leased properties in aggregate, the land is considered material.

When the land component of the lease agreement is considered immaterial (FMV land < 25% total FMV), the lease should be accounted for as a single lease unit. The lessee should capitalize the lease if one of the following occurs:

1. The term of the lease is 75% or more of the economic useful life of the real estate.
2. The present value of the minimum lease payments equals 90% or more of the fair market value of the leased real estate less any lessor tax credits.

If neither of the two criteria above is met, the lessee should account for the lease agreement as a single operating lease.

When the land component of the lease agreement is considered material (FMV land < 25% total FMV), the land and building components should be separated. By applying the lessee's incremental borrowing rate to the fair market value of the land, the annual minimum lease payment attributed to land is computed. The remaining payments are attributed to the building. The division of minimum lease payments between land and building is essential for both the lessee and lessor. The lease involving the land should *always* be accounted for as an operating lease. Under US GAAP, the lease involving the building(s) must meet either the 75% (of useful life) or 90% (of fair value) test to be treated as a capital lease. If neither of the two criteria is met, the building(s) will also be accounted for as an operating lease.

**Lessor accounting.** The lessor's accounting depends on whether the lease transfers ownership, contains a bargain purchase option, or does neither of the two. If the lease transfers ownership and gives rise to dealer's profit (or loss), US GAAP requires that the lessor classify the lease as a sales-type lease and account for the lease as a single unit under the provisions of FAS 66 in the same manner as a seller of the same property. If the lease transfers ownership, meets both the collectibility and no important uncertainties criteria, but does not give rise to dealer's profit (or loss), the lease should be accounted for as a direct financing or leveraged lease as appropriate.

If the lease contains a bargain purchase option and gives rise to dealer's profit (or loss), the lease should be classified as an operating lease. If the lease contains a bargain purchase option, meets both the collectibility and no material uncertainties criteria, but does not give

rise to dealer's profit (or loss), the lease should be accounted for as a direct financing lease or a leveraged lease, as appropriate.

If the lease agreement neither transfers ownership nor contains a bargain purchase option, the lessor should follow the same rules as the lessee in accounting for real estate leases involving land and building(s).

However, the collectibility and the no material uncertainties criteria must be met before the lessor can account for the agreement as a direct financing lease, and in no such case may the lease be classified as a sales-type lease (i.e., ownership must be transferred).

The treatment of a lease involving both land and building can be illustrated in the following examples.

**Example of accounting for land and building lease containing transfer of title**

Assume the following:

1. The lessee enters into a 10-year non-cancellable lease for a parcel of land and a building for use in its operations. The building has an estimated useful life of 12 years.
2. The FMV of the land is €75,000, while the FMV of the building is €310,000.
3. A payment of €50,000 is due to the lessor at the beginning of each of the 10 years of the lease.
4. The lessee's incremental borrowing rate is 10%. (Lessor's implicit rate is unknown.)
5. Ownership will transfer to the lessee at the end of the lease.

The present value of the minimum lease payments is €337,951 ( $€50,000 \times 6.75902^*$ ). The portion of the present value of the minimum lease payments that should be capitalized for each of the two components of the lease is computed as follows:

FMV of land	€ 75,000	
FMV of building	310,000	
Total FMV of leased property	<b>€385,000</b>	
Portion of PV allocated to land		$€337,951 \times \frac{75,000}{385,000} = €65,835$
Portion of PV allocated to building		$€337,951 \times \frac{310,000}{385,000} = 272,116$
Total PV to be capitalized	<b>€337,951</b>	

The entry made to record the lease initially is as follows:

Leased land	65,835	
Leased building	272,116	
Lease obligation		337,951

\* 6.75902 is the PV of an annuity due for 10 periods at 10%.

Subsequently, the obligation will be decreased in accordance with the effective interest method. The leased building will be amortized over its expected useful life.

**Example of accounting for land and building lease without transfer of title or bargain purchase option**

Assume the same facts as in the previous example except that title does not transfer at the end of the lease.

The lease is still a capital lease because the lease term is more than 75% of the useful life. Since the FMV of the land is less than 25% of the leased properties in aggregate ( $€75,000/€385,000 =$

19%), the land component is considered immaterial and the lease will be accounted for as a single lease. The entry to record the lease is as follows:

Leased property	337,951	
Lease obligation		337,951

Assume the same facts as in the previous example except that the FMV of the land is €110,000 and the FMV of the building is €275,000. Once again, title does not transfer.

Because the FMV of the land exceeds 25% of the leased properties in aggregate ( $\frac{€110,000}{€385,000} = 28\%$ ), the land component is considered material and the lease would be separated into two components. The annual minimum lease payment attributed to the land is computed as follows:

$$\begin{array}{r} \text{FMV of land} \\ \text{PV factor} \end{array} \frac{€100,000}{6.75902^*} = €16,275$$

The remaining portion of the annual payment is attributed to the building.

Annual payment	€ 50,000
Less amount attributed to land	(16,275)
Annual payment attributed to building	<u>€33,725</u>

The present value of the minimum annual lease payments attributed to the building is then computed as follows:

Minimum annual lease payment attributed to building	€ 33,725
PV factor	× 6.75902*
PV of minimum annual lease payments attributed to building	€ <u>227,948</u>

The entry to record the capital portion of the lease is as follows:

Leased building	227,948
Lease obligation	227,948

\* 6.75902 is the PV of an annuity due for 10 periods at 10%.

There would be no computation of the present value of the minimum annual lease payment attributed to the land since the land component of the lease will be treated as an operating lease. For this reason, each year, €16,275 of the €50,000 lease payment will be recorded as land rental expense. The remainder of the annual payment (€33,725) will be applied against the lease obligation using the effective interest method.

### Leases Involving Real Estate and Equipment

When real estate leases also involve equipment or machinery, the equipment component should be separated and accounted for as a separate lease agreement by both lessees and lessors. According to US GAAP, “the portion of the minimum lease payments applicable to the equipment element of the lease shall be estimated by whatever means are appropriate in the circumstances.” The lessee and lessor should apply the capitalization requirements to the equipment lease independently of accounting for the real estate lease(s). The real estate leases should be handled as discussed in the preceding two sections. In a sale-leaseback transaction involving real estate with equipment, the equipment and land are not separated.

### Leases Involving Only Part of a Building

It is common to find lease agreements that involve only part of a building, as, for example, when a floor of an office building is leased or when a store in a shopping mall is leased. A difficulty that arises in this situation is that the cost and/or fair market value of the leased portion of the whole may not be determinable objectively.



<b>Treatment of selected items in accounting for leases under US GAAP</b>				
	<u>Operating</u>	<u>Lessor Direct financing and sales-type</u>	<u>Operating</u>	<u>Lessee capital</u>
Initial direct costs	Capitalize and amortize over lease term in proportion to rent revenue recognized (normally SL basis)	Direct financing:  Record in separate account Add to net investment in lease Compute new effective rate that equates gross amt. of min. lease payments and unguar. residual value with net invest. Amortize so as to produce constant rate of return over lease term Sales-type: Expense in period incurred Reduces FMV of leased asset for 90% test	N/A	N/A
Investment tax credit retained by lessor	N/A		N/A	Reduces FMV of leased asset for 90% test
Bargain purchase option	N/A	Include in: Minimum lease payments 90% test	N/A	Include in: Minimum lease payments 90% test
Guaranteed residual value	N/A	Include in: Minimum lease payments 90% test Sales-type: Include PV in sales revenues	N/A	Include in: Minimum lease payments 90% test
Unguaranteed residual value	N/A	Include in: "Gross Investment in Lease" Not included in: 90% test Sales-type: Exclude from sales revenue Deduct PV from cost of sales	N/A	Include in: Minimum lease payments 90% test
Contingent rentals	Revenue in period earned	Not part of minimum lease payments; revenue in period earned	Expense in period incurred	Not part of minimum lease payments; expense in period incurred
Amortization period	Amortize down to estimated residual value over estimated economic life of asset	N/A	N/A	Amortize down to estimated residual value over lease term or estimated economic life <sup>c</sup>
Revenue (expense) <sup>a</sup>	Rent revenue (normally SL basis)  Amortization (depreciation expense)	Direct financing: Interest revenue on net investment in lease (gross investment less unearned interest income) Sales-type: Dealer profit in period of sale (sales revenue less cost of leased asset) Interest revenue on net investment in lease	Rent expense (normally SL basis) <sup>b</sup>	Interest expense and depreciation expense

<sup>a</sup> Elements of revenue (expense) listed for the items above are not repeated here (e.g., treatment of initial direct costs).

<sup>b</sup> If payments are not on a SL basis, recognize rent expense on a SL basis unless another systematic and rational method is more representative of use benefit obtained from the property, in which case, the other method should be used.

<sup>c</sup> If lease has automatic passage of title or bargain purchase option, use estimated economic life; otherwise, use the lease term.

For the lessee, if the fair value of the leased property is objectively determinable, the lessee should follow the rules and account for the lease as described in “leases involving land and building.” If the fair value of the leased property cannot be determined objectively but the agreement satisfies the 75% test, the estimated economic life of the building in which the leased premises are located should be used. If this test is not met, the lessee should account for the agreement as an operating lease.

From the lessor’s position, both the cost and fair value of the leased property must be objectively determinable before the procedures described under “leases involving land and building” will apply. If either the cost or the fair value cannot be determined objectively, the lessor should account for the agreement as an operating lease.

### **Termination of a Lease**

The lessor shall remove the remaining net investment from his or her books and record the leased equipment as an asset at the lower of its original cost, present fair value or current carrying value. The net adjustment is reflected in income of the current period.

The lessee is also affected by the terminated agreement because he or she has been relieved of the obligation. If the lease is a capital lease, the lessee should remove both the obligation and the asset from his or her accounts and charge any adjustment to the current period income. If accounted for as an operating lease, no accounting adjustment is required.

### **Renewal or Extension of an Existing Lease**

The renewal or extension of an existing lease agreement affects the accounting of both the lessee and the lessor. US GAAP specifies two basic situations in this regard: (1) the renewal occurs and makes a residual guarantee or penalty provision inoperative, or (2) the renewal agreement does not do the foregoing and the renewal is to be treated as a new agreement. The accounting treatment prescribed under the latter situation for a lessee is as follows:

1. If the renewal or extension is classified as a capital lease, the (present) current balances of the asset and related obligation should be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the (present) current balance of the obligation. The present value of the minimum lease payments under the revised agreement should be computed using the interest rate that was in effect at the inception of the original lease.
2. If the renewal or extension is classified as an operating lease, the current balances in the asset and liability accounts are removed from the books and a gain (loss) recognized for the difference. The new lease agreement resulting from a renewal or extension is accounted for in the same manner as other operating leases.

Under the same circumstances, US GAAP prescribes the following treatment to be followed by the lessor:

1. If the renewal or extension is classified as a direct financing lease, then the existing balances of the lease receivable and the estimated residual value accounts should be adjusted for the changes resulting from the revised agreement.

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*NOTE: Remember that an upward adjustment of the estimated residual value is not allowed.*

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- The net adjustment should be charged or credited to an unearned income account.
2. If the renewal or extension is classified as an operating lease, the remaining net investment under the existing sales-type lease or direct financing lease is removed from the books and the leased asset recorded as an asset at the lower of its original cost, present fair value or current carrying amount. The difference between the net investment and the amount recorded for the leased asset is charged to profit or loss of the period. The renewal or extension is then accounted for as for any other operating lease.
  3. If the renewal or extension is classified as a sales-type lease *and* it occurs at or near the end of the existing lease term, the renewal or extension should be accounted for as a sales-type lease.

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*NOTE: A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term.*

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If the renewal or extension causes the guarantee or penalty provision to be inoperative, the lessee adjusts the current balance of the leased asset and the lease obligation to the present value of the future minimum lease payments (according to the relevant standard, “by an amount equal to the difference between the PV of future minimum lease payments under the revised agreement and the present balance of the obligation”). The PV of the future minimum lease payments is computed using the implicit rate used in the original lease agreement.

Given the same circumstances, the lessor adjusts the existing balance of the lease receivable and estimated residual value accounts to reflect the changes of the revised agreement (remember, no upward adjustments to the residual value). The net adjustment is charged (or credited) to unearned income.

### **Leases between Related Parties**

Leases between related parties are classified and accounted for as though the parties are unrelated, except in cases where it is clear that the terms and conditions of the agreement have been influenced significantly by the fact of the relationship. When this is the case, the classification and/or accounting is modified to reflect the true economic substance of the transaction rather than the legal form.

If a subsidiary’s principal business activity is leasing property to its parent or other affiliated companies, consolidated financial statements are presented. The US GAAP standard on related parties requires that the nature and extent of leasing activities between related parties be disclosed.

### **Accounting for Leases in a Business Combination**

A business combination, in and of itself, has no effect on the classification of a lease. However, if, in connection with a business combination, the lease agreement is modified to change the original classification of the lease, it should be considered a new agreement and reclassified according to the revised provisions.

In most cases, a business combination that is accounted for by the pooling-of-interest method or by the purchase method will not affect the previous classification of a lease unless the provisions have been modified as indicated in the preceding paragraph.

The acquiring company should apply the following procedures to account for a leveraged lease in a business combination accounted for by the purchase method:

1. The classification of leveraged lease should be kept.
2. The net investment in the leveraged lease should be given a fair market value (present value, net of tax) based on the remaining future cash flows. Also, the estimated tax effects of the cash flows should be given recognition.
3. The net investment should be broken down into three components: net rentals receivable, estimated residual value and unearned income.
4. Thereafter, the leveraged lease should be accounted for as described above in the section on leveraged leases.

### **Sale or Assignment to Third Parties—Non-Recourse Financing**

The sale or assignment of a lease or of property subject to a lease that was originally accounted for as a sales-type lease or a direct financing lease will not affect the original accounting treatment of the lease. Any profit or loss on the sale or assignment should be recognized at the time of transaction except under the following two circumstances:

1. When the sale or assignment is between related parties, apply the provisions presented above under “Leases between Related Parties.”
2. When the sale or assignment is with recourse, it should be accounted for using the provisions of the US GAAP standard on sale of receivables with recourse.

The sale of property subject to an operating lease should not be treated as a sale if the seller (or any related party to the seller) retains substantial risks of ownership in the leased property. A seller may retain substantial risks of ownership by various arrangements. For example, if the lessee defaults on the lease agreement or if the lease terminates, the seller may arrange to do one of the following:

1. Acquire the property or the lease.
2. Substitute an existing lease.
3. Secure a replacement lessee or a buyer for the property under a remarketing agreement.

A seller will not retain substantial risks of ownership by arrangements where one of the following occurs:

1. A remarketing agreement includes a reasonable fee to be paid to the seller.
2. The seller is not required to give priority to the releasing or disposition of the property owned by the third party over similar property owned by the seller.

When the sale of property subject to an operating lease is not accounted for as a sale because the substantial risk factor is present, it should be accounted for as a borrowing. The proceeds from the sale should be recorded as an obligation on the seller’s books. Rental payments made by the lessee under the operating lease should be recorded as revenue by the seller even if the payments are paid to the third-party purchaser. The seller shall account for each rental payment by allocating a portion to interest expense (to be imputed in accordance with the provisions of APB 21), and the remainder will reduce the existing obligation. Other normal accounting procedures for operating leases should be applied except that the depreciation term for the leased asset is limited to the amortization period of the obligation.

The sale or assignment of lease payments under an operating lease by the lessor should be accounted for as a borrowing as described above.

Non-recourse financing is a common occurrence in the leasing industry whereby the stream of lease payments on a lease is discounted on a non-recourse basis at a financial institution with the lease payments collateralizing the debt. The proceeds are then used to finance future leasing transactions. Even though the discounting is on a non-recourse basis, US GAAP prohibits the offsetting of the debt against the related lease receivable unless a legal right of offset exists or the lease qualified as a leveraged lease at its inception.

### **Money-Over-Money Lease Transactions**

In cases where a lessor obtains non-recourse financing in excess of the leased asset's cost, a technical bulletin states that the borrowing and leasing are separate transactions and should not be offset against each other unless a right of offset exists. Only dealer profit in sales-type leases may be recognized at the beginning of the lease term.

### **Acquisition of Interest in Residual Value**

Recently, there has been an increase in the acquisition of interests in residual values of leased assets by companies whose primary business is other than leasing or financing. This generally occurs through the outright purchase of the right to own the leased asset or the right to receive the proceeds from the sale of a leased asset at the end of its lease term.

In instances such as these, the rights should be recorded by the purchaser at the fair value of the assets surrendered. Recognition of increases in the value of the interest in the residual (i.e., residual value accretion) to the end of the lease term is prohibited. However, a non-temporary write-down of the residual value interest should be recognized as a loss. This guidance also applies to lessors who sell the related minimum lease payments but retain the interest in the residual value. Guaranteed residual values also have no effect on this guidance.

### **Accounting for a Sublease**

A sublease is used to describe the situation where the original lessee re-leases the leased property to a third party (the sublessee), and the original lessee acts as a sublessor. Normally, the nature of a sublease agreement does not affect the original lease agreement, and the original lessee/sublessor retains primary liability.

The original lease remains in effect, and the original lessor continues to account for the lease as before. The original lessee/sublessor accounts for the lease as follows:

1. If the original lease agreement transfers ownership or contains a bargain purchase option and if the new lease meets any one of the four criteria specified in US GAAP (i.e., transfers ownership, BPO, the 75% test or the 90% test) and both the collectibility and uncertainties criteria, the sublessor should classify the new lease as a sales-type or direct financing lease; otherwise, as an operating lease. In either situation, the original lessee/sublessor should continue accounting for the original lease obligation as before.
2. If the original lease agreement does not transfer ownership or contain a bargain purchase option, but it still qualified as a capital lease, the original lessee/sublessor should (with one exception) apply the usual criteria set by US GAAP in classifying the new agreement as a capital or operating lease. If the new lease qualifies for capital

treatment, the original lessee/sublessor should account for it as a direct financing lease, with the unamortized balance of the asset under the original lease being treated as the cost of the leased property. The one exception arises when the circumstances surrounding the sublease suggest that the sublease agreement was an important part of a predetermined plan in which the original lessee played only an intermediate role between the original lessor and the sublessee. In this situation, the sublease should be classified by the 75% and 90% criteria as well as collectibility and uncertainties criteria. In applying the 90% criterion, the fair value for the leased property will be the fair value to the original lessor at the inception of the original lease. Under all circumstances, the original lessee should continue accounting for the original lease obligation as before. If the new lease agreement (sublease) does not meet the capitalization requirements imposed for subleases, the new lease should be accounted for as an operating lease.

3. If the original lease is an operating lease, the original lessee/sublessor should account for the new lease as an operating lease and account for the original operating lease as before.

## APPENDIX B: LEVERAGED LEASES UNDER US GAAP

One of the most complex accounting subjects regarding leases is the accounting for a leveraged lease. Once again, as with both sales-type and direct financing, the classification of the lease by the lessor has no effect on the accounting treatment accorded the lease by the lessee. The lessee simply treats it as any other lease and thus is interested only in whether the lease qualifies as an operating or a capital lease. The lessor's accounting problem is substantially more complex than that of the lessee.

Leveraged leases are not directly addressed under IFRS. However, such three-party leasing transactions may be encountered occasionally. This guidance under US GAAP is therefore offered to fill a void in IFRS literature.

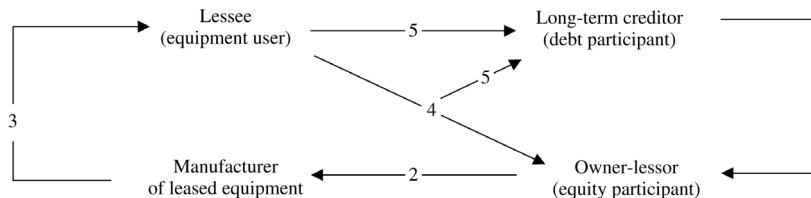
To qualify as a leveraged lease, a lease agreement must meet the following requirements, and the lessor must account for the investment tax credit (when in effect) in the manner described below.

*NOTE: Failure to do so will result in the lease being classified as a direct financing lease.*

1. The lease must meet the definition of a direct financing lease. (The 90% of FMV criterion does not apply.)<sup>1</sup> A direct financing lease must have its cost or carrying value equal to the fair value of the asset at the inception of the lease. Thus, even if the amounts are not significantly different, leveraged lease accounting should not be used.
2. The lease must involve at least three parties:
  - a. An owner-lessor (equity participant).
  - b. A lessee.
  - c. A long-term creditor (debt participant).
3. The financing provided by the creditor is non-recourse as to the general credit of the lessor and is sufficient to provide the lessor with substantial leverage.
4. The lessor's net investment (defined below) decreases in the early years and increases in the later years until it is eliminated.

The last characteristic (item 4) poses the accounting problem.

The leveraged lease arose as a result of an effort to maximize the tax benefits associated with a lease transaction. To accomplish this, it was necessary to involve a third party to the lease transaction (in addition to the lessor and lessee), a long-term creditor. The following diagram illustrates the existing relationships in a leveraged lease agreement:



*The leveraged lease arrangement\**

\* Adapted from "A Straightforward Approach to Leveraged Leasing" by Pierce R. Smith, *The Journal of Commercial Bank Lending*, July 1973, pp. 40-47.

<sup>1</sup> A direct financing lease must have its cost or carrying value equal to the fair value of the asset at the inception of the lease. Thus, even if the amounts are not significantly different, leveraged lease accounting should not be used.

1. The owner-lessor secures long-term financing from the creditor, generally in excess of 50% of the purchase price. US GAAP indicates that the lessor must be provided with sufficient leverage in the transaction; thus the 50%.
2. The owner then uses this financing along with his or her own funds to purchase the asset from the manufacturer.
3. The manufacturer delivers the asset to the lessee.
4. The lessee remits the periodic rent to the lessor.
5. The debt is guaranteed by either using the equipment as collateral, the assignment of the lease payments, or both, depending on the demands established by the creditor.

The FASB concluded that the entire lease agreement be accounted for as a single transaction and not a direct financing lease plus a debt transaction. The feeling was that the latter did not readily convey the net investment in the lease to the user of the financial statements. Thus, the lessor is to record the investment as a net amount. The gross investment is calculated as a combination of the following amounts:

1. The rentals receivable from the lessee, net of the principal and interest payments due to the long-term creditor.
2. A receivable for the amount of the investment tax credit (ITC) to be realized on the transaction (repealed in the United States but may yet exist in other jurisdictions).
3. The estimated residual value of the leased asset.
4. The unearned and deferred income, consisting of:
  - a. The estimated pre-tax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income.
  - b. The ITC remaining to be allocated to profit or loss over the remaining term of the lease.

The first three amounts described above are readily obtainable; however, the last amount, the unearned and deferred income, requires additional computations. To derive this amount, it is necessary to create a cash flow (income) analysis by year for the entire lease term. As described in item 4 above, the unearned and deferred income consists of the pre-tax lease income (Gross lease rentals – Depreciation – Loan interest) and the unamortized investment tax credit. The total of these two amounts for all the periods in the lease term represents the unearned and deferred income at the inception of the lease.

The amount computed as the gross investment in the lease (foregoing paragraphs) less the deferred taxes relative to the difference between pre-tax lease income and taxable lease income is the net investment for purposes of computing profit or loss for the period. To compute the periodic profit or loss, another schedule must be completed that uses the cash flows derived in the first schedule and allocates them between income and a reduction in the net investment.

The amount of profit or loss is first determined by applying a rate to the net investment. The rate to be used is the rate that will allocate the entire amount of cash flow (income) when applied in the years in which the net investment is positive. In other words, the rate is derived in much the same way as the implicit rate (trial and error), except that only the years in which there is a positive net investment are considered. Thus, income is recognized only in the years in which there is a positive net investment.

The profit or loss recognized is divided among the following three elements:

1. Pre-tax accounting income.
2. Amortization of investment tax credit.
3. The tax effect of the pre-tax accounting income.



The first two are allocated in proportionate amounts from the unearned and deferred income included in calculation of the net investment. In other words, the unearned and deferred income consists of pre-tax lease accounting income and any investment tax credit. Each of these is recognized during the period in the proportion that the current period's allocated income is to the total income (cash flow). The last item, the tax effect, is recognized in the tax expense for the year. The tax effect of any difference between pre-tax lease accounting income and taxable lease income is charged (or credited) to deferred taxes.

When tax rates change, all components of a leveraged lease must be recalculated from the inception of the lease, using the revised after-tax cash flows arising from the revised tax rates.

If, in any case, the projected cash receipts (income) are less than the initial investment, the deficiency is to be recognized as a loss at the inception of the lease. Similarly, if at any time during the lease period the aforementioned method of recognizing income would result in a future period loss, the loss shall be recognized immediately.

This situation may arise as a result of the circumstances surrounding the lease changing. Therefore, any estimated residual value and other important assumptions must be reviewed on a periodic basis (at least annually). Any change is to be incorporated into the income computations; however, there is to be no upward revision of the estimated residual value.

The following example illustrates the application of these principles to a leveraged lease.

#### Example of simplified leveraged lease

Assume the following:

1. A lessor acquires an asset for €100,000 with an estimated useful life of three years in exchange for a €25,000 down payment and a €75,000 three-year note with equal payments due on December 31 each year. The interest rate is 18%.
2. The asset has no residual value.
3. The PV of an ordinary annuity of €1 for three years at 18% is 2.17427.
4. The asset is leased for three years with annual payments due to the lessor on December 31 in the amount of €45,000.
5. The lessor uses the ACRS method of depreciation for tax purposes and elects to reduce the ITC rate to 4%, as opposed to reducing the depreciable basis.
6. Assume a constant tax rate throughout the life of the lease of 40%.

Chart 1 analyses the cash flows generated by the leveraged leasing activities. Chart 2 allocates the cash flows between the investment in leveraged leased assets and income from leveraged leasing activities. The allocation requires finding that rate of return which, when applied to the investment balance at the beginning of each year that the investment amount is positive, will allocate the net cash flow fully to net income over the term of the lease. This rate can be found only by a computer program or by an iterative trial-and-error process. The example that follows has a positive investment value in each of the three years, and thus the allocation takes place in each time period. Leveraged leases usually have periods where the investment account turns negative and is below zero.

Allocating principal and interest on the loan payments is as follows:

$$€75,000 \div 2.17427 = €34,494$$

<u>Year</u>	<u>Payment</u>	<u>Interest 18%</u>	<u>Principal</u>	<u>Balance</u>
Inception of lease	€ --	€ --	€ --	€75,000
1	€34,494	€13,500	€20,994	€54,006
2	€34,494	€ 9,721	€24,773	€29,233
3	€34,494	€ 5,261	€29,233	--

**Chart 1**

	A	B	C	D	E	F	G	H	I
	<i>Income tax</i>								
				<i>Taxable income</i>	<i>payable (rcvbl.)</i>	<i>Loan principal payments</i>			<i>Cumulative cash flow</i>
	<u>Rent</u>	<u>Depr.</u>	<u>Interest on loan</u>	<u>(A-B-C)</u>	<u>Dx40%</u>	<u>payments</u>	<u>ITC</u>	<u>(A+G-C-E-F)</u>	<u>flow</u>
Initial	€ --	€ --	€ --	€ --	€ --	€ --	€ --	€(25,000)	€(25,000)
Year 1	45,000	25,000	13,500	6,500	2,600	0,994	4,000	11,906	(13,094)
Year 2	45,000	38,000	9,721	(2,721)	(1,088)	24,773	--	11,594	(1,500)
Year 3	45,000	37,000	5,261	2,739	1,096	29,233	--	9,410	7,910
Total	<u>€135,000</u>	<u>€100,000</u>	<u>€28,482</u>	<u>€6,518</u>	<u>€2,608</u>	<u>€75,000</u>	<u>€4,000</u>	<u>€7,910</u>	

The chart below allocates the cash flows determined above between the net investment in the lease and income. Recall that the income is then allocated between pre-tax accounting income and the amortization of the investment for credit. The income tax expense for the period is a result of applying the tax rate to the current periodic pre-tax accounting income.

The amount to be allocated in total in each period is the net cash flow determined in column H above. The investment at the beginning of year 1 is the initial down payment of €25,000. This investment is then reduced on an annual basis by the amount of the cash flow not allocated to income.

**Chart 2**

	1	2	3	4	5	6	7
	<i>Flow Cash flow Assumption</i>				<i>Income Analysis</i>		
	<i>Investment beginning of year</i>		<i>Allocated to investment</i>	<i>Allocated to income</i>	<i>Pre-tax income</i>	<i>Income tax expense</i>	<i>Investment tax credit</i>
	<u>year</u>	<u>Cash flow</u>	<u>investment</u>	<u>income</u>	<u>income</u>	<u>expense</u>	<u>credit</u>
Year 1	€25,000	€11,906	€ 7,964	€3,942	€3,248	€1,300	€1,994
Year 2	€ 17,036	€11,594	€ 8,908	€ 2,686	€ 2,213	€ 885	€1,358
Year 3	€ 8,128	€ 9,410	€ 8,128	€ 1,282	€ 1,057	€ 423	€ 648
		<u>€32,910</u>	<u>€25,000</u>	<u>€7,910</u>	<u>€6,518</u>	<u>€2,608</u>	<u>€4,000</u>

Rate of return = 15.77%

- Column 2 is the net cash flow after the initial investment, and Columns 3 and 4 are the allocation based on the 15.77% rate of return. The total of Column 4 is the same as the total of Column H in Chart 1.
- Column 5 allocates Column D in Chart 1 based on the allocations in Column 4. Column 6 allocates Column E in Chart 1, and Column 7 allocates Column G in Chart 1 in the same basis.

The journal entries below illustrate the proper recording and accounting for the leveraged lease transaction. The initial entry represents the cash down payment, investment tax credit receivable, the unearned and deferred revenue, and the net cash to be received over the term of the lease.

The remaining journal entries recognize the annual transactions that include the net receipt of cash and the amortization of income.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Rents receivable [Chart 1 (A-C-F)]	31,518		
Investment tax credit receivable	4,000		
Cash		25,000	
Unearned and deferred income		10,518	
[Initial investment, Chart 2 (5+7) totals]			

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Cash	10,506	10,506	10,506
Rent receivable	10,506	10,506	10,506
[Net for all cash transactions, Chart 1 (A-C-F) line by line for each year]			
Income tax receivable (cash)	4,000		
Investment tax credit receivable	4,000		
Unearned and deferred income	5,242	3,571	1,705
Income from leveraged leases	5,242	3,571	1,705

[Amortization of unearned income, Chart 2 (5+7) line by line for each year]

The following schedules illustrate the computation of deferred income tax amount. The annual amount is a result of the temporary difference created due to the difference in the timing of the recognition of income for book and tax purposes. The income for tax purposes can be found in Column D in Chart 1, while the income for book purposes is found in Column 5 of Chart 2. The actual amount of deferred tax is the difference between the tax computed with the temporary difference and the tax computed without the temporary difference. These amounts are represented by the income tax payable or receivable as shown in Column E of Chart 1 and the income tax expense as shown in Column 6 of Chart 2. A check of this figure is provided by multiplying the difference between book and tax income by the annual rate.

	<u>Year 1</u>		
Income tax payable		€ 2,600	
Income tax expense		€ (1,300)	
Deferred income tax (Dr)			€ <u>1,300</u>
Taxable income		€ 6,500	
Pre-tax accounting income		€ (3,248)	
Difference			€ <u>3,252</u>
$€3,252 \times 40\% = €1,300$			
	<u>Year 2</u>		
Income tax receivable		€ 1,088	
Income tax expense		€ <u>885</u>	
Deferred income tax (Cr)			€ <u>1,973</u>
Taxable loss		€ 2,721	
Pre-tax accounting income		€ <u>2,213</u>	
Difference			€ <u>4,934</u>
$€4,934 \times 40\% = €1,973$			
	<u>Year 3</u>		
Income tax payable		€ 1,096	
Income tax expense		€ (423)	
Deferred income tax (Dr)			€ <u>673</u>
Taxable income		€ 2,739	
Pre-tax accounting income		€ (1,057)	
Difference		€ <u>1,682</u>	
$€1,682 \times 40\% = €673$			

In addition to foreign operations, an entity may have foreign currency transactions (e.g., export and import transactions denominated in the foreign currency). These give rise to other financial reporting implications, which are also addressed in this chapter. Note that even a purely domestic company may have transactions (e.g., with foreign suppliers or customer) denominated in foreign currencies, and these same guidelines will apply in those circumstances, as well.

IFRS governing the translation of foreign currency financial statements and the accounting for foreign currency transactions are found primarily in IAS 21, *The Effects of Changes in Foreign Exchange Rates*. IAS 21 applies to:

1. Accounting for foreign currency transactions (e.g., exports, imports and loans) which are denominated in other than the reporting entity's functional currency.
2. Translation of foreign currency financial statements of branches, divisions, subsidiaries and other investees that are incorporated in the financial statements of an entity by consolidation, proportionate consolidation or the equity method of accounting.

## DEFINITIONS OF TERMS

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**Closing rate.** This refers to the spot exchange rate (defined below) at the end of the reporting period.

**Conversion.** The exchange of one currency for another.

**Exchange difference.** The difference resulting from reporting the same number of units of a foreign currency in the presentation currency at different exchange rates.

**Exchange rate.** This refers to the ratio for exchange between two currencies.

**Fair value.** The amount for which an asset could be exchanged, or a liability could be settled, between knowledgeable willing parties in an arm's-length transaction.

**Foreign currency.** A currency other than the functional currency of the reporting entity (e.g., the Japanese yen is a foreign currency for a euro-reporting entity).

**Foreign currency financial statements.** Financial statements that employ as the unit of measure a foreign currency that is not the presentation currency of the entity.

**Foreign currency transactions.** Transactions whose terms are denominated in a foreign currency or require settlement in a foreign currency. Foreign currency transactions arise when an entity:

1. Buys or sells goods or services whose prices are denominated in foreign currency;
2. Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency;
3. Is a party to an unperformed foreign exchange contract; or
4. For other reasons acquires or disposes of assets or incurs or settles liabilities denominated in foreign currency.

**Foreign currency translation.** The process of expressing in the presentation currency of the entity amounts that are denominated or measured in a different currency.

**Foreign entity.** When the activities of a foreign operation are not an integral part of those of the reporting entity, such a foreign operation is referred to as a foreign entity.

**Foreign operation.** A foreign subsidiary, associate, joint venture or branch of the reporting entity whose activities are based or conducted in a country other than the country where the reporting entity is domiciled.

**Functional currency.** The currency of the primary economic environment in which the entity operates, which thus is the currency in which the reporting entity measures the items in its financial statements, and which may differ from the presentation currency in some instances.

**Group.** A parent company and all of its subsidiaries.

**Monetary items.** Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

**Net investment in a foreign operation.** The amount refers to the reporting entity's interest in the net assets of that foreign operation.

**Non-monetary items.** All items presented in the statement of financial position other than cash, claims to cash and cash obligations.

**Presentation currency.** The currency in which the reporting entity's financial statements are presented. There is no limitation on the selection of a presentation currency by a reporting entity.

**Reporting entity.** An entity or group whose financial statements are being referred to. Under this standard, those financial statements reflect (1) the financial statements of one or more foreign operations by consolidation, proportionate consolidation or equity accounting; (2) foreign currency transactions; or (3) both of the foregoing.

**Spot exchange rate.** The exchange rate for immediate delivery of currencies exchanged.

**Transaction date.** In the context of recognition of exchange differences from settlement of monetary items arising from foreign currency transactions, transaction date refers to the date at which a foreign currency transaction (e.g., a sale or purchase of merchandise or services the settlement for which will be in a foreign currency) occurs and is recorded in the accounting records.

## SCOPE, OBJECTIVES AND DISCUSSION OF DEFINITIONS

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The objective of IAS 21 is to prescribe (1) how to include foreign currency transactions and foreign operations in the financial statements of an entity, and (2) how to translate financial statements into a presentation currency. The scope of IAS 21 applies to:

1. Accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of IAS 39, *Financial Instruments: Recognition and Measurement*. However, those foreign currency derivatives that are not within the scope of IAS 39 (e.g., some foreign currency derivatives that are embedded in other contracts), and the translation of amounts relating to derivatives from its functional currency to its presentation currency are within the scope of this standard;
2. Translating the financial position and financial results of *foreign operations* that are included in the financial statements of the reporting entity as a result of consolidation, proportionate consolidation or the equity method; and
3. Translating an entity's financial statements into a *presentation currency*.

IAS 21 does not apply to the presentation, in the statement of cash flows, of cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation, which are within the scope of IAS 7, *Statement of Cash Flows*.

## Functional Currency

The concept of *functional currency* is key to understanding translation of foreign currency financial statements. Functional currency is defined as being the currency of the primary economic environment in which an entity operates. This is normally, but not necessarily, the currency in which that entity principally generates and expends cash.

In determining the relevant functional currency, an entity would give primary consideration to the following factors:

1. The currency that mainly influences sales prices for goods and services, as well as the currency of the country whose competitive forces and regulations mainly determine the sales prices of the entity's goods and services; and
2. The currency that primarily influences labour, material, and other costs of providing those goods or services.

Note that the currency which influences selling prices is often that currency in which sales prices are denominated and settled, while the currency that most influences the various input costs is normally that in which input costs are denominated and settled. There are many situations in which input costs and output prices will be denominated in or influenced by differing currencies (e.g., an entity which manufactures all of its goods in Mexico, using locally sourced labour and materials, but sells all or most of its output in Europe in euro-denominated transactions).

In addition to the foregoing, IAS 21 notes other factors which may provide additional evidence of an entity's functional currency. These may be deemed secondary considerations, and these are:

1. The currency in which funds from financing activities (i.e., from the issuance of debt and equity instruments) are generated; and
2. The currency in which receipts from operating activities are usually retained.

In making a determination of whether the functional currency of a foreign operation (e.g., a subsidiary, branch, associate or joint venture) is the same as that of the reporting entity (parent, investor, etc.), certain additional considerations may also be relevant. These include:

1. Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being executed more or less autonomously;
2. What proportion of the foreign operation's activities is comprised of transactions with the reporting entity;
3. Whether the foreign operation's cash flows directly impact upon the cash flows of the reporting entity, and are available for prompt remittance to the reporting entity; and
4. Whether the foreign operation is largely cash flow independent (i.e., if its own cash flows are sufficient to service its existing and reasonably anticipated debts without the injection of funds by the reporting entity).

Foreign operations are characterized as being adjuncts of the operations of the reporting entity when, for example, the foreign operation only serves to sell goods imported from the reporting entity and in turn remits all sales proceeds to the reporting entity. On the other hand, the foreign operation is seen as being essentially autonomous when it accumulates cash

and other monetary items, incurs expenses, generates income and arranges borrowings, all done substantially in its local currency.

In practice, there are many gradations along the continuum between full autonomy and the state of being a mere adjunct to the reporting entity's operations. When there are mixed indications, and thus the identity of the functional currency is not obvious, judgement is required to make this determination. The selection of the functional currency should most faithfully represent the economic effects of the underlying transactions, events and conditions. According to IAS 21, however, priority attention is to be given to the identity of the currency (or currencies) that impact selling prices for outputs of goods and services, and inputs for labour and materials and other costs. The other factors noted above are to be referred to secondarily, when a clear conclusion is not apparent from considering the two primary factors.

#### Example

A US-based company, Majordomo, Inc., has a major subsidiary located in the UK, John Bull Co., which produces and sells goods to customers almost exclusively in EU member states. Transactions are effected primarily in euros, both for sales and, to a lesser extent, for raw materials purchases. The functional currency is determined to be euros in this instance, given the facts noted. Transactions are to be measured in euros, accordingly. For purposes of the John Bull Co.'s stand-alone financial reporting, euro-based financial data will be translated into pounds Sterling, using the translation rules set forth in revised IAS 21. For consolidation of the UK subsidiary into the financial statements of parent entity Majordomo, Inc., translation into US dollars will be required, again using the procedures defined in the standard.

In some cases the determination of functional currency can be complex and time-consuming. The process is difficult especially if the foreign operation acts as an investment company or holding company within a group and has few external transactions. Management must document the approach followed in the determination of the functional currency for each entity within a group—particularly when factors are mixed and judgement is required.

Once determined, an entity's functional currency will rarely be altered. However, since the entity's functional currency is expected to reflect its most significant underlying transactions, events and conditions, there obviously can be a change in functional currency if there are fundamental changes in those circumstances. For example, if the entity's manufacturing and sales operations are relocated to another country, and inputs are thereafter sourced from that new location, this may justify changing the functional currency for that operation. When there is a change in an entity's functional currency, the entity should apply the translation procedures applicable to the new functional currency *prospectively* from the date of the change.

If the functional currency is the currency of a hyperinflationary economy, as that term is defined under IAS 29, *Financial Reporting in Hyperinflationary Economies*, the entity's financial statements are restated in accordance with the provisions of that standard. IAS 21 stresses that an entity cannot avert such restatement by employing tactics such as adopting an alternate functional currency, such as that of its parent entity. There are currently very few such economies in the world, but this situation of course may change in the future. There are also instances that have been noted where economies have experienced severe hyperinflation and have been unable to restate their financial statements in terms of the procedures required

by IAS 29 due to the unavailability of reliable information on restatement factors. The difficulties experienced by reporters in such jurisdictions have been addressed by the IASB, in that IFRS 1, *First-time Adoption of International Financial Reporting Standards*, was amended and now permits the re-adoption of IFRS by such entities through the application of exceptions and exemptions provided for in this standard.

### Monetary and Non-Monetary Items

For purposes of applying IAS 21, it is important to understand the distinction between monetary and non-monetary items. Monetary items are those granting or imposing “a right to receive, or an obligation to deliver, a fixed or determinable number of units of currency.” In contrast, non-monetary items are those exhibiting “the absence of a right to receive, or an obligation to deliver, a fixed or determinable number of units of currency.” Examples of monetary items include accounts and notes receivable; pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; and cash dividends that are properly recognized as a liability. Examples of non-monetary items include inventories; amounts prepaid for goods and services (e.g., prepaid insurance); property, plant and equipment; goodwill; other intangible assets; and provisions that are to be settled by the delivery of a non-monetary asset.

## FOREIGN CURRENCY TRANSACTIONS

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Foreign currency transactions are those denominated in, or requiring settlement in, a foreign currency. These can include such common transactions as those arising from:

1. The purchase or sale of goods or services in transactions where the price is denominated in a foreign currency;
2. The borrowing or lending of funds, where the amounts owed or to be received are denominated in a foreign currency; or
3. Other routine activities such as the acquisition or disposal of assets, or the incurring or settlement of liabilities, if denominated in a foreign currency.

Under the provisions of IAS 21, foreign currency transactions are to be initially recorded in the functional currency by applying to the foreign-currency-denominated amounts the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. However, when there are numerous, relatively homogeneous transactions over the course of the reporting period (e.g., year), it is acceptable, and much more practical, to apply an appropriate average exchange rate provided such an average would approximate the spot rates applicable. In the simplest scenario, the simple numerical average (i.e., the midpoint between the beginning and ending exchange rates) could be used. Care must be exercised to ensure that such a simplistic approach is actually meaningful, however.

If exchange rate movements do not occur smoothly throughout the reporting period, or if rates move alternately up and down over the reporting interval, rather than monotonically up or down, then a more carefully constructed, weighted-average exchange rate should be used. Also, if transactions occur in other than a smooth pattern over the period—as might be the case for products characterized by seasonal sales—then a weighted-average exchange rate might be needed if exchange rates have moved materially over the course of the reporting period. For example, if the bulk of revenues is generated in the fourth quarter, the annual



average exchange rate would probably not result in an accurately translated statement of comprehensive income.

**Example**

Continuing the preceding example, the UK-based subsidiary, John Bull, which produces and sells goods to customers almost exclusively in EU member states, also had sizeable sales to a Swiss company, denominated in Swiss francs. These occurred primarily in the fourth quarter of the year, when the Swiss franc-euro exchange rate was atypically strong. In converting these sales to the functional currency (euros), the average exchange rate in the fourth quarter was deemed to be most relevant.

Subsequent to the date of the underlying transaction, there may be a continuing need to translate the foreign-currency-denominated event into the entity's functional currency. For example, a purchase or sale transaction may have given rise to an account payable or an account receivable, which remains unsettled at the next financial reporting date (e.g., the following month-end). According to IAS 21, at each end of the reporting period the foreign currency *monetary* items (such as payables and receivables) are to be translated using the closing rate (i.e., the exchange rate at the date of the statement of financial position).

**Example**

If John Bull Co. (from the preceding examples) acquires receivables denominated in a foreign currency, Swiss francs (CHF), in 20XX, these are translated into the functional currency, euros, at the date of the transaction. If the CHF-denominated receivables are still outstanding at year-end, the company will translate those (ignoring any allowance for uncollectibles) into euros at the year-end exchange rate. If these remain outstanding at the end of 20XX+1 (again ignoring collectibility concerns), these will be translated into euros using the *year-end 20XX* exchange rate.

To the extent that exchange rates have changed since the transaction occurred (which will likely happen), exchange differences will have to be recognized by the reporting entity, since the amount due to or from a vendor or customer, denominated in a foreign currency, is now more or less valuable than when the transaction occurred.

**Example**

Assume now that John Bull Co. acquired the above-noted receivables denominated in Swiss francs in 20XX, when the exchange rate of the Swiss franc versus the euro was CHF 1 = € .65. At year-end 20XX, the rate is CHF 1 = € .61, and by year-end 20XX, the euro has further strengthened to CHF 1 = € .58. Assume that John Bull acquired CHF 10,000 of receivables in mid-20XX, and all remain outstanding at year-end 20XX+1. (Again, for purposes of this example only, ignore collectibility concerns.)

At the date of initial recognition, John Bull records accounts receivable denominated in CHF in the euro equivalent value of €6,500, since the euro is the functional currency (translation to British pounds or US dollars—a presentation currency—will be dealt with later). At year-end 20XX these receivables are the equivalent of only €6,100, and as a result a loss of €400, which must be recognized in the company's 20XX profit and loss statement. In effect, by holding CHF-denominated receivables while the Swiss franc declined in value against the euro, John Bull suffered a loss. The Swiss franc further weakens over 20XX+1, so that by year-end the CHF 10,000 of receivables will be worth only €5,800, for a further loss of €300 in 20XX+1, which again is to be recognized currently in John Bull's profit and loss statement.

*Non-monetary* items (such as property purchased for the company's foreign operation), on the other hand, are to be translated at historical exchange rates. The actual historical exchange rate to be used, however, depends on whether the non-monetary item is being reported on the historical cost basis, or on a revalued basis, in those instances where the latter method of reporting is permitted under IFRS. If the non-monetary items are measured in terms of historical cost in a foreign currency, then these are to be translated by using the exchange rate at the actual historical date of the transaction. If the item has been restated to a fair value measurement, then it must be translated into the functional currency by applying the exchange rate at the date when the fair value was determined.

**Example—historical cost accounting employed by reporting entity**

Assume that John Bull Co. acquired machinery from a Swiss manufacturer, in a transaction denominated in Swiss francs in 20XX, when the CHF-euro exchange rate was CHF 1 = €.65. The price paid was CHF 250,000. For purposes of this example, ignore depreciation. At the transaction date, John Bull Co. records the machinery at €162,500. This same amount will be presented in the year-end 20XX and 20XX+1 statements of financial position. The change in exchange rates subsequent to the transaction date will not be considered, since machinery is a non-monetary asset.

**Example—revaluation accounting employed by reporting entity**

Assume again that John Bull Co. acquired machinery from a Swiss manufacturer, in a transaction denominated in Swiss francs in 20XX, when the CHF-euro exchange rate was CHF 1 = €.65. The price paid was CHF 250,000. For purposes of this example, ignore depreciation. At year-end 20XX, John Bull Co. elects to use the allowed alternative method of accounting under IAS 16, and determines that the fair value of the machinery is CHF 285,000. In the entity's year-end statement of financial position, this is reported at the euro equivalent of the revalued amount, using the exchange rate at the revaluation date, or €173,850 (= CHF 285,000 × €.61). This same amount will appear in the 20XX+1 statement of financial position (assuming no further revaluation is undertaken post-20XX).

If a non-monetary asset was acquired in a foreign currency transaction by incurring debt which is to be repaid in the foreign currency (e.g., when a building for the foreign operation was financed locally by commercial debt), subsequent to the actual transaction date the translation of the asset and the related debt will be at differing exchange rates (unless rates remain unchanged, which is not likely to happen.) The result will be either a gain or a loss, which reflects the fact that a non-monetary asset was purchased but the burden of the related obligation for future payment will vary as the exchange rates fluctuate over time, until the debt is ultimately settled—in other words, the reporting entity has assumed exchange rate risk. On the other hand, if the debt were obtained in the reporting (parent) entity's home country or were otherwise denominated in the buyer's functional currency, there would be no exchange rate risk and no subsequent gain or loss resulting from such an exposure.

**Example**

Assume now that John Bull Co. acquired machinery from a Swiss manufacturer, in a transaction denominated in Swiss francs in 20XX, when the CHF-euro exchange rate was CHF 1 = €.65. The price paid was CHF 250,000. For purposes of this example, ignore depreciation. At the transaction date, John Bull Co. records the machinery at €162,500. This same amount will be presented in the year-end 20XX and 20XX+1 statements of financial

position. The change in exchange rates subsequent to the transaction date will not be considered, since machinery is a non-monetary asset.

However, the purchase of the machinery was effected by signing a five-year note, payable in Swiss francs. Assume for simplicity the note is not subject to amortization (i.e., due in full at maturity). The note is recorded, at transaction date, as a liability of €162,500. However, at year-end 20XX, since the euro has strengthened, the obligation is the equivalent of €152,500. As a result an exchange gain of €10,000 is reported in profit or loss in the current period.

At year-end 20XX+1, this obligation has the euro-equivalent value of €145,000, and thus a further gain of €7,500 is recognized by John Bull Co. for financial reporting purposes.

Had the machinery been acquired for a euro-denominated obligation of €162,500, this valuation would remain in the financial statements until ultimately retired. In this case, the Swiss machinery manufacturer, not the British customer (whose functional currency is the euro), accepted exchange rate risk, and John Bull Co. will report no gain or loss arising from exchange differences.

Other complications can arise when accounting for transactions executed in a foreign currency. IAS 21 identifies circumstances where the carrying amount of an item is determined by comparing two or more amounts, for example when inventory is to be presented at the lower of cost or net realizable value, consistent with the requirements of IAS 2, *Inventories*. Another cited example pertains to long-lived assets, which must be reviewed for impairment, per IAS 36, *Impairments of Assets*. In situations such as these (i.e., where the asset is non-monetary and is measured in a foreign currency) the carrying amount in terms of functional currency is determined by comparing:

1. The cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e., the rate at the date of the transaction for an item measured in terms of historical cost, or the date of revaluation if the item were restated under relevant IFRS); and
2. The net realizable value or recoverable amount, as appropriate, translated at the exchange rate at the date when *that* value was determined (which would normally be the closing rate at the end of the reporting period).

Note that by comparing translated amounts that are determined using exchange rate ratios as of differing dates, the actual effect of performing the translation will reflect two economic phenomena; namely, the IFRS-driven lower of cost or fair value comparison (or equivalent), and the changing exchange rates. The effect may be that an impairment loss is to be recognized in the functional currency when it would not have been recognized in the foreign currency, or the opposite relationship may hold (and, of course, there could be impairments in either case, albeit for differing amounts).

#### Example

John Bull Co. acquired raw materials inventory from a Swiss manufacturer, in a transaction denominated in Swiss francs in 20XX+1, when the CHF-euro exchange rate was CHF 1 = € .65. The price paid was CHF 34,000. At year-end, when the exchange rate was CHF 1 = € .61, the net realizable value of the inventory, which was still on hand, was CHF 32,000. Applying the IAS 21 requirements, it is determined that (1) the purchase price in euros was €22,100 (= CHF 34,000 × € .65), and (2) NRV at the end of the reporting period is €19,520 (= CHF 32,000 × € .61). A lower of cost or realizable value impairment adjustment is reported equal to €2,580. (= €22,100 – €19,520).

## TRANSLATION OF FOREIGN CURRENCY FINANCIAL STATEMENTS

IAS 21 adopted the functional currency approach that requires the foreign entity to present all of its transactions in its functional currency. Translation is the process of converting transactions denominated in its functional currency into the investor's presentation currency. If an entity's transactions are denominated in other than its functional currency, the foreign transactions must first be adjusted to their equivalent functional currency value before translating to the presentation currency (if different than the functional currency). Three different situations that can arise in translating foreign currency financial statements are illustrated in the following example:

Foreign entity's local currency	Foreign entity's functional currency	Investor's presentation currency	Translation method	Exchange differences
Euro	Euro	Canadian dollar	Translation to the presentation currency at the closing rate for all assets and liabilities	Other comprehensive income (OCI) and equity
Euro	Canadian dollar	Canadian dollar	Translation to the functional currency (which is also the presentation currency) at the closing rate for all monetary items	Gain (or loss) in profit or loss
Swiss franc	Euro	Canadian dollar	1. Translation to the functional currency (€) 2. Translation to the presentation currency (Can \$)	Gain (or loss) in profit or loss OCI and equity

IAS 21 prescribes two sets of requirements when translating foreign currency financial statements. The first of these deals with reporting foreign currency *transactions* by each individual entity, which may also be part of reporting group (e.g., consolidated parent and subsidiaries) in the individual entities' functional currencies or remeasuring the foreign currency financial statements into the functional currency. The second set of requirements is for the translation of entities' financial statements (e.g., those of subsidiaries) from the functional currency into presentation currency (e.g., of the parent). These matters are addressed in the following paragraphs.

### *Translation of functional currency financial statements into a presentation currency*

If the investor's presentation currency (e.g., Canadian dollar) differs from the foreign entity's functional currency (e.g., euro), the foreign entity's financial statements have to be translated into the presentation currency when preparing consolidated financial statements. In accordance with IAS 21, the method used for translation of the foreign currency financial

statements from the functional currency into the presentation currency is essentially what is commonly called the *current (closing) rate* method under US GAAP. In general, the translation methods under both IFRS and US GAAP are the same, except for the translation of financial statements in hyperinflationary economies (See Chapter 35).

Under the translation to the presentation currency approach, all assets and liabilities, both monetary and non-monetary, are translated at the closing (end of the reporting period) rate, which simplifies the process compared to all other historically advocated methods. More importantly, this more closely corresponds to the viewpoint of financial statement users, who tend to relate to currency exchange rates in existence at the end of the reporting period rather than to the various specific exchange rates that may have applied in prior months or years.

However, financial statements of preceding years should be translated at the rate(s) appropriately applied when these translations were first performed, (i.e., these are *not* to be updated to current closing or average rates). This rule applies because it would cause great confusion to users of financial statements if amounts once reported (when current) were now all restated even though no changes were being made to the underlying data, and of course the underlying economic phenomena, now one or more years in the past, cannot have changed since initially reported upon.

The theoretical basis for this translation approach is the “net investment concept,” wherein the foreign entity is viewed as a separate entity that the parent invested into, rather than being considered as part of the parent’s operations. Information provided about the foreign entity retains the internal relationships and results created in the foreign environments (economic, legal and political) in which the entity operates. This approach works best, of course, when foreign-denominated debt is used to purchase the assets that create foreign-denominated revenues; these assets thus serve as a hedge against the effects caused by changes in the exchange rate on the debt. Any excess (i.e., net) assets will be affected by this foreign exchange risk, and this is the effect that is recognized in the parent company’s statement of financial position, as described below.

The following rules should be used in translating the financial statements of a foreign entity:

1. All assets and liabilities in the current year-end statement of financial position, whether monetary or non-monetary, should be translated at the closing rate in effect at the date of that statement of financial position.
2. Income and expense items in each statement of comprehensive income should be translated at the exchange rates at the dates of the transactions, except when the foreign entity reports in a currency of a hyperinflationary economy (as defined in IAS 29), in which case they should be translated at the closing rates.
3. All resulting exchange differences should be recognized in other comprehensive income and reclassified from equity to profit or loss on the disposal of the net investment in a foreign entity.
4. All assets and liabilities in *prior period* statements of financial position, being presented currently (e.g., as comparative information) whether monetary or non-monetary, are translated at the exchange rates (closing rates) in effect at the date of each of the statements of financial position.
5. Income and expense items in *prior period* statements of income, being presented currently (e.g., as comparative information), are translated at the exchange rates as of the dates of the original transactions (or averages, where appropriate).

Under the translation to the presentation currency approach, all assets and liabilities are valued (1) higher, as a result of a direct exchange rate increase, or (2) lower, as a result of a direct rate decrease. Since the liabilities offset a portion of the assets, constituting a natural hedge, only the subsidiary's net assets (assets in excess of liabilities) are exposed to the risk of fluctuations in the currency exchange rates. As a result, the effect of the exchange rate change can be calculated by multiplying the foreign entity's average net assets by the change in the exchange rate.

On the books of the parent, the foreign entity's net asset position is reflected in the parent's investment account. If the equity method is applied, the investment account should be adjusted upward or downward to reflect changes in the exchange rate; if a foreign entity is included in the consolidated financial statements, the investment account is eliminated. (See "Comprehensive Example: Translation into the Presentation Currency" later in this chapter).

### ***Translation (remeasurement) of financial statements into a functional currency***

When a foreign entity keeps its books and records in a currency other than its functional currency, translation of foreign currency items presented in the statement of financial position into functional currency (remeasurement) is driven by the distinction between monetary and non-monetary items. Foreign currency monetary items are translated using the closing rate (the spot exchange rate at the end of the reporting period). Foreign currency non-monetary items are translated using the historical exchange rates. There is a presumption that the effect of exchange rate changes on the foreign operation's net assets will directly affect the parent's cash flows, so the exchange rate adjustments are reported in the parent's profit or loss.

For example, branch sales offices or production facilities of a large, integrated operation (e.g., the European field operation of a US corporation, which is principally supplied by the home office but which occasionally also enters into local currency transactions) would qualify for this treatment. Since the US dollar influences sales prices, most (but not all) of its sales are US dollar denominated, and most of its costs, including merchandise, are the result of US transactions, the application of the previously mentioned criteria would conclude that the functional currency of the European sales office is the US dollar, and translation of foreign-currency-denominated assets and liabilities, and transactions would follow the monetary/non-monetary distinction noted above with the effect of exchange rate differences reported in profit or loss.

In general, translation of non-monetary items (inventory, plant assets, etc.) is done by applying the historical exchange rates. The historical rates usually are those in effect when the asset was acquired or (less often) when the non-monetary liability was incurred, but if there was a subsequent revaluation, if this is permitted under IFRS, then using the exchange rate at the date when the fair value was determined.

When a gain or loss on a non-monetary item is recognized in profit or loss (e.g., from applying lower of cost or realizable value for inventory), any exchange component of that gain or loss should be recognized in profit or loss. When, on the other hand, a gain or loss on a non-monetary item is recognized under IFRS in other comprehensive income (e.g., from revaluation of plant assets, or from fair value adjustments made to available-for-sale-securities investments), any exchange component of that gain or loss should also be recognized in other comprehensive income.

As a result of conversion into functional currency, if a foreign unit is in a net monetary asset position (monetary assets in excess of monetary liabilities), an increase in the direct

exchange rate causes a favourable result (gain) to be reported in profit or loss; if it is in a net monetary liability position (monetary liabilities in excess of monetary assets), it reports an unfavourable result (loss). If a foreign unit is in a net monetary asset position, a decrease in the direct exchange rate causes an unfavourable result (loss) to report, but if it is in a net monetary liability position, a favourable result (gain) is reported.

In cases when an entity keeps its books and records in a currency (e.g., Swiss franc) other than its functional currency (e.g., euro), and other than the presentation currency of the parent (e.g., Canadian dollar), the two-step translation process would be required: (1) translation of the financial statements (e.g., from Swiss franc) into functional currency (e.g., euro) and (2) translation of functional currency (e.g., euro) into the reporting currency (e.g., Canadian dollar).

### ***Net investment in a foreign operation***

A special rule applies to a net investment in a foreign operation. According to IAS 21, when the reporting entity has a monetary item that is receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future, this is, in substance, a part of the entity's net investment in its foreign operation. This item should be accounted for as follows:

1. Exchange differences arising from translation of monetary items forming part of the net investment in the foreign operation should be reflected in profit or loss in the *separate* financial statements of the reporting entity (investor/parent) and in the separate financial statements of the foreign operation; *but*
2. In the consolidated financial statements which include the investor/parent and the foreign operation, the exchange difference should be recognized initially in other comprehensive income and reclassified from equity to profit or loss upon disposal of the foreign operation.

Note that when a monetary item is a component of a reporting entity's net investment in a foreign operation and it is denominated in the functional currency of the reporting entity, an exchange difference arises only in the foreign operation's individual financial statements. Conversely, if the item is denominated in the functional currency of the foreign operation, an exchange difference arises only in the reporting entity's separate financial statements.

### ***Consolidation of foreign operations***

The most commonly encountered need for translating foreign currency financial statements into the investor entity reporting currency is when the parent entity is preparing consolidated financial statements, and one or more of the subsidiaries have reported in their respective (local) currencies. The same need presents itself if an investee or joint venture's financial information is to be incorporated via the proportionate consolidation or the equity methods of accounting. When consolidating the assets, liabilities, income, and expenses of a foreign operation with those of the reporting entity, the general consolidation processes apply, including the elimination of intragroup balances and intragroup transactions. Goodwill and any adjustments to the carrying amounts of foreign operation's assets and liabilities should be expressed in the functional currency and translated using the closing rate.

**Comprehensive example: Translation into the presentation currency**

Assume that a US company has a 100%-owned subsidiary in Germany that began operations in 20XX. The subsidiary's operations consist of utilizing company-owned space in an office building. This building, which cost five million euros, was financed primarily by German banks, although the parent did invest two million euros in the German operation. All revenues and cash expenses are received and paid in euros. The subsidiary also maintains its books and records in euros, its functional currency.

The financial statements of the German subsidiary are to be translated (from the functional currency euros to the presentation currency US dollars) for incorporation into the US parent's financial statements. The subsidiary's statement of financial position at December 31, 20XX, and its combined statement of income and retained earnings for the year ended December 31, 20XX, are presented below in euros.

**German Company**  
**Statement of Financial Position**  
**December 31, 20XX**  
**(in thousands of €)**

<i>Assets</i>		<i>Liabilities and shareholders' equity</i>	
Cash	€ 500	Accounts payable	€ 300
Note receivable	200	Unearned rent	100
Land	1,000	Mortgage payable	4,000
Building	5,000	Ordinary shares	400
Accumulated depreciation	<u>(100)</u>	Additional paid-in capital	1,600
		Retained earnings	<u>200</u>
Total assets	<b><u>€6,600</u></b>	Total liabilities and shareholders' equity	<b><u>€6,600</u></b>

**German Company**  
**Combined Statement of Profit or Loss and Retained Earnings**  
**For the Year Ended December 31, 20XX**  
**(in thousands of €)**

Revenues	€2,000
Operating expenses (including depreciation expense of €100)	<u>1,700</u>
Profit for the year	300
Add retained earnings, January 1, 20XX-1	—
Deduct dividends	<u>(100)</u>
Retained earnings, December 31, 20XX-1	<b><u>€ 200</u></b>

Various *assumed* exchange rates for 20XX are as follows:

- €1 = \$0.90 at the beginning of 20XX (when the ordinary shares were issued and the land and building were financed through the mortgage)
- €1 = \$1.05 weighted-average for 20XX
- €1 = \$1.10 at the date the dividends were declared and the unearned rent was received
- €1 = \$1.20 closing (December 31, 20XX)

The German company's financial statements must be translated into US dollars in terms of the provisions of IAS 21 (i.e., by the current rate method). This translation process is illustrated below.



**German Company**  
**Statement of Financial Position Translation**  
**December 31, 20XX**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
<i>Assets</i>			
Cash	€ 500	1.20	\$ 600
Accounts receivable	200	1.20	240
Land	1,000	1.20	1,200
Building (net)	<u>4,900</u>	1.20	<u>5,880</u>
Total assets	<u>€6,600</u>		<u>\$7,920</u>
<i>Liabilities and shareholders' equity</i>			
Accounts payable	€ 300	1.20	\$ 360
Unearned rent	100	1.20	120
Mortgage payable	4,000	1.20	4,800
Ordinary shares	400	0.90	360
Additional paid-in capital	1,600	0.90	1,440
		(see combined income and retained earnings statement translation)	
Retained earnings	200		205
Cumulative exchange difference (translation adjustments)	=	-	635
Total liabilities and shareholders' equity	<u>€6,600</u>		<u>\$7,920</u>

**German Company**  
**Combined Statement of Profit or Loss and Retained Earnings Translation**  
**For the Year Ended December 31, 20XX**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
Revenues	€2,000	1.05	\$2,100
Expenses (including €100 depreciation expense)	<u>1,700</u>	1.05	<u>1,785</u>
Profit for the year	300		315
Add retained earnings, January 1	-	-	-
Deduct dividends	<u>(100)</u>	1.10	<u>(110)</u>
Retained earnings, December 31	<u>€200</u>		<u>\$205</u>

**German Company**  
**Statement of Cash Flows Translation**  
**For the Year Ended December 31, 20XX**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
<i>Operating activities</i>			
Profit for the year	€ 300	1.05	\$ 315
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	100	1.05	105

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
Increase in accounts receivable	(200)	1.05	(210)
Increase in accounts payable	300	1.05	315
Increase in unearned rent	<u>100</u>	1.10	<u>110</u>
Net cash provided by operating activities	600		635
<b>Investing activities</b>			
Purchase of land	(1,000)	0.90	(900)
Purchase of building	<u>(5,000)</u>	0.90	<u>(4,500)</u>
Net cash used by investing activities	(6,000)		(5,400)
<b>Financing activities</b>			
Ordinary shares issue	2,000	0.90	1,800
Mortgage payable	4,000	0.90	3,600
Dividends paid	<u>(100)</u>	1.10	<u>(110)</u>
Net cash provided by financing	5,900		5,290
Effect on exchange rate changes on cash	<u>N/A</u>		<u>75</u>
Increase in cash and equivalents	500		600
Cash at beginning of year	<u>—</u>		<u>—</u>
Cash at end of year	<u>€500</u>	<u>1.20</u>	<u>\$ 600</u>

The following points should be noted concerning the translation into the presentation currency:

- All assets and liabilities are translated using the closing rate at the end of the reporting period (€1 = \$1.20). All revenues and expenses should be translated at the rates in effect when these items are recognized during the period. Due to practical considerations, however, weighted-average rates can be used to translate revenues and expenses (€1 = \$1.05) only if such weighted-average rates approximate actual rates that were ruling at the time of the transactions.
- Shareholders' equity accounts are translated by using historical exchange rates. Ordinary shares were issued at the beginning of 20XX-2 when the exchange rate was €1 = \$0.90. The translated balance of retained earnings is the result of the weighted-average rate applied to revenues and expenses and the specific rate in effect when the dividends were declared (€1 = \$1.10).
- Cumulative exchange differences (translation adjustments) result from translating all assets and liabilities at the closing (current) rate, while shareholders' equity is translated by using historical and weighted-average rates. The adjustments have no direct effect on cash flows; however, changes in exchange rate will have an indirect effect on sale or liquidation. Prior to this time, the effect is uncertain and remote. Also, the effect is due to the net investment rather than the subsidiary's operations. For these reasons the translation adjustments balance is reported as "an other comprehensive income item" in the statement of comprehensive income and as a separate component in the shareholders' equity section of the US company's consolidated statement of financial position. This balance essentially equates the total debits of the subsidiary (now expressed in US dollars) with the total credits (also in dollars). It may also be determined directly, as shown next, to verify the translation process.
- The cumulative exchange differences (translation adjustments) credit of \$635 is calculated as follows:

Net assets at the beginning of 20XX-2 (after ordinary shares were issued and the land and building were acquired through mortgage financing)	€2,000(1.20 – 0.90)	= \$600 credit
Profit for the year	€300 (1.20 – 1.05)	= 45 credit
Dividends	€100 (1.20 – 1.10)	= <u>10 debit</u>
Exchange difference (translation adjustment)		<u>\$635 credit</u>

5. Since the net exchange differences (translation adjustment) balance that appears as a separate component of shareholders' equity is cumulative in nature, the change in this balance during the year should be disclosed in the financial statements. In the illustration, this balance went from zero to \$635 at the end of 20XX-1. The analysis of this change was presented previously. The translation adjustment has a credit balance because the German entity was in a net asset position during the period (assets in excess of liabilities) and the spot exchange rate at the end of the period is higher than the exchange rate at the beginning of the period or the average for the period.

In addition to the foregoing transactions, assume that the following occurred during 20XX+1:

<b>German Company</b>			
<b>Statement of Financial Position</b>			
<b>December 31, 20XX+1</b>			
<b>(in thousands of €)</b>			
	<u>20XX</u>	<u>20XX-1</u>	<u>Increase/(decrease)</u>
<b>Assets</b>			
Cash	€1,000	€ 500	€500
Accounts receivable	–	200	(200)
Land	1,500	1,000	500
Building (net)	<u>4,800</u>	<u>4,900</u>	<u>(100)</u>
Total assets	<u>€7,300</u>	<u>€6,600</u>	<u>€700</u>
<b>Liabilities and shareholders' equity</b>			
Accounts payable	€ 500	€ 300	€200
Unearned rent	–	100	(100)
Mortgage payable	4,500	4,000	500
Ordinary shares	400	400	–
Additional paid-in capital	1,600	1,600	–
Retained earnings	<u>300</u>	<u>200</u>	<u>100</u>
Total liabilities and shareholders' equity	<u>€7,300</u>	<u>€6,600</u>	<u>€700</u>

**German Company**  
**Combined Statement of Profit or Loss and Retained Earnings**  
**For the Year Ended December 31, 20XX+1**  
**(in thousands of €)**

Revenues	€2,200
Operating expenses (including depreciation expense of €100)	<u>1,700</u>
Profit for the year	500
Add: Retained earnings, January 1, 20XX	200
Deduct dividends	<u>(400)</u>
Retained earnings, December 31, 20XX	<u>€300</u>

Exchange rates were

€1 = \$1.20 at the beginning of 20XX+1

€1 = \$1.16 weighted-average for 20XX+1

€1 = \$1.08 closing (December 31, 20XX+1)

€1 = \$1.10 when dividends were paid in 20XX and land bought by incurring mortgage

The translation process for 20XX+1 is illustrated below.

**German Company**  
**Statement of Financial Position Translation**  
**December 31, 20XX+1**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
<i>Assets</i>			
Cash	€1,000	1.08	\$1,080
Land	1,500	1.08	1,620
Building	4,800	1.08	5,184
Total assets	<u>€7,300</u>		<u>\$7,884</u>
<i>Liabilities and shareholders' equity</i>			
Accounts payable	€ 500	1.08	\$ 540
Mortgage payable	4,500	1.08	4,860
Ordinary shares	400	0.90	360
Addl. paid-in capital	1,600	0.90	1,440
		(see combined income and retained earnings statement translation)	
Retained earnings	300		345
Cumulative translation adjustments	–		339
Total liabilities and shareholders' equity	<u>€7,300</u>		<u>\$7,884</u>

**German Company**  
**Combined Statement of Profit or Loss and Retained Earnings Translation**  
**For the Year Ended December 31, 20XX+1**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
Revenues	€2,200	1.16	\$2,552
Operating expenses (including depreciation of €100)	1,700	1.16	1,972
Profit for the year	500	1.16	580
Add: Retained earnings 1/1/20XX	200	–	205
Less: Dividends	<u>(400)</u>	1.10	<u>(440)</u>
Retained earnings 12/31/20XX	<u>€300</u>		<u>\$345</u>

**German Company**  
**Statement of Cash Flows Translation**  
**For the Year Ended December 31, 20XX+1**  
**(in thousands of €)**

	<u>Euros</u>	<u>Exchange rates</u>	<u>US dollars</u>
<i>Operating activities</i>			
Profit for the year	€ 500	1.16	\$ 580
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	100	1.16	116
Decrease in accounts receivable	200	1.16	232
Increase in accounts payable	200	1.16	232
Decrease in unearned rent	<u>(100)</u>	1.16	<u>(116)</u>
Net cash provided by operating activities	900		1,044

**Investing activities**

Purchase of land	(500)	1.10	(550)
Net cash used in investing activities	(500)		(550)

**Financing activities**

Mortgage payable	500	1.10	550
Dividends	(400)	1.10	(440)
Net cash provided by financing activities	100		110
Effect of exchange rate changes on cash	N/A		(124)
Increase in cash and equivalents	500		480
Cash at beginning of year	500		600
Cash at end of year	<u>€1,000</u>	1.08	<u>\$1,080</u>

Using the same mode of analysis that was presented before, the total exchange differences (translation adjustment) attributable to 20XX+1 would be computed as follows:

Net assets at January 1, 20XX	€2,200 (1.08 – 1.20) =	\$264 credit
Net income for 20XX	€500 (1.08 – 1.16) =	40 credit
Dividends for 20XX	€400 (1.08 – 1.10) =	8 debit
Total		\$296 credit

The balance in the exchange differences (translation adjustment) account at the end of 20XX would be \$339 (\$635 from 20XX-1 less \$296 from 20XX). The balance in this account decreased during 20XX since the German entity was in a net asset position during the period and the spot exchange rate at the end of the period (closing rate) is lower than the exchange rate at the beginning of the period or the average for the period.

6. Use of the equity method by the US company in accounting for the subsidiary would result in the following journal entries based on the information presented above:

	<u>20XX-1</u>		<u>20XX</u>
<b>Original investment</b>			
Investment in German subsidiary	1,800*		–
Cash		1,800	–
* [\$0.90 × common share of €400 plus additional paid-in capital of €1,600]			
<b>Earnings pickup</b>			
Investment in German subsidiary	315*		580**
Equity in subsidiary income		315	580
* [\$1.05 × net income of €300]			
** [\$1.16 × net income of €500]			
<b>Dividends received</b>			
Cash	110*		440**
Investment in German subsidiary		110	440
<b>Exchange difference (translation adjustments)</b>			
Investment in German subsidiary	635		
OCI (Translation adjustments)		635	
OCI (Translation adjustments)			296
Investment in German subsidiary			296

\*[\$1.10 × dividend of €100]

\*\*[\$1.10 × dividend of €400]

Note that the shareholders' equity of the US company should be the same whether or not the German subsidiary is consolidated. Since the subsidiary does not report the translation adjustments on its financial statements, care should be exercised so that it is not forgotten in application of the equity method.

7. If the US company disposes of its investment in the German subsidiary, the translation adjustments balance becomes part of the gain or loss that results from the transaction and must be eliminated. For example, assume that on January 2, 20XX+1, the US company sells its entire investment for €3,000. The exchange rate at this date is €1 = \$1.08. The balance in the investment account at December 31, 20XX+1 is \$2,484 as a result of the entries made previously.

	Investment in German Subsidiary	
1/1/13	1,800	
	315	110
	635	
1/1/14	2,640	
	580	440
		296
12/31/14	2,484	

The following entries would be made to reflect the sale of the investment:

Cash (€3,000 × \$1.08)	3,240	
Investment in German subsidiary		2,484
Gain from sale of subsidiary		756
Translation adjustments	339	
Gain from sale of subsidiary		339

If the US company had sold a portion of its investment in the German subsidiary, only a proportionate share of the translation adjustments balance (cumulative amount of exchange differences) would have become part of the gain or loss from the transaction. To illustrate, if 80% of the German subsidiary was sold for €2,500 on January 2, 20XX+2, the following journal entries would be made:

Cash (€2,500 × \$1.08)	2,700.00	
Investment in German subsidiary (0.8 × \$2,484)		1,987.20
Gain from sale of subsidiary		712.80
Cumulative exchange difference (translation adjustments)	271.20	
(0.8 × \$339)		
Gain from sale of subsidiary		271.20

## **GUIDANCE APPLICABLE TO SPECIAL SITUATIONS**

### ***Non-controlling interests***

When a foreign entity is consolidated, but it is not wholly owned by the reporting entity, there will be non-controlling interest reported in the consolidated statement of financial position. IAS 21 requires that the accumulated exchange differences resulting from

translation and attributable to the non-controlling interest be allocated to and reported as non-controlling interest in net assets.

### ***Goodwill and fair value adjustments***

Any goodwill arising on the acquisition of a foreign entity and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation should be treated as assets and liabilities of the foreign operation. Thus they should be expressed in the functional currency of the foreign operation and translated at the closing rate in accordance with IAS 21.

### ***Exchange differences arising from elimination of intragroup balances***

While incorporating the financial statements of a foreign entity into those of the reporting entity, normal consolidation procedures such as elimination of intragroup balances and transactions are undertaken as required by IAS 27, IAS 28 and IAS 31.

### ***Different reporting dates***

When reporting dates for the financial statements of a foreign entity and those of the reporting entity differ, the foreign entity normally switches and prepares financial statements with reporting dates coinciding with those of the reporting entity. However, sometimes this may not be practicable to do. Under such circumstances IAS 27 allows the use of financial statements prepared as of different dates, provided that the difference is no more than three months. In such a case, the assets and liabilities of the foreign entity should be translated at the exchange rates prevailing at the end of the reporting period of the foreign entity. Adjustments should be made for any significant movements in exchange rates between the end of the reporting period of the foreign entity and that of the reporting entity in accordance with the provisions of IAS 27, IAS 28 and IAS 31 relating to this matter.

### ***Disposal of a foreign entity***

Any cumulative exchange differences are to be recognized in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign entity. The standard prescribes the treatment of the cumulative exchange differences account on the disposal of the foreign entity. This balance, which has been deferred, should be reclassified from equity to profit or loss in the same period in which the gain or loss on disposal is recognized.

Disposal has been defined to include a sale, liquidation, repayment of share capital, or abandonment of all or part of the entity. Normally, payment of dividends would not constitute a repayment of capital. However, in rare circumstances, it does; for instance, when an entity pays dividends out of capital instead of accumulated profits, as defined in the companies' acts of certain countries, such as the United Kingdom, this would constitute repayment of capital. In such circumstances, obviously, dividends paid would constitute a disposal for the purposes of this standard.

IAS 21 further stipulates that in the case of a partial disposal of an interest in a foreign entity, only a proportionate share of the related accumulated exchange differences is recognized as a gain or a loss. A write-down of the carrying amount of the foreign entity does not constitute a partial disposal, and thus the deferred exchange differences carried forward as part of equity would not be affected by such a write-down.

### *Change in functional currency*

If there is a change in the functional currency, an entity should apply the translation procedures applicable to the new functional currency prospectively from the date of this change.

### **Reporting a Foreign Operation's Inventory**

Under IAS 21, only a single method can be used for translating functional currency financial statements into the presentation currency. Specifically, the reporting entity is required to translate the assets and liabilities of its foreign operations and foreign entities at the closing (end of the reporting period) rate, and required to translate income and expenses at the exchange rates at the dates of the transactions (or at the average rate for the period, if this offers a reasonable approximation of actual transaction date rates).

As noted previously, sometimes an adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting entity even though such an adjustment was not necessary in the separate, foreign-currency-based financial statements of the foreign operation. This stipulation of IAS 21 can best be illustrated by the following case study.

#### **Example**

Inventory of merchandise owned by a foreign operation of the reporting entity is being carried by the foreign operation at 3,750,000 SR (Saudi riyals) in its statement of financial position. Suppose that the indirect exchange rate fluctuated from 3.75 SR = 1 US dollar at September 15, 20XX+1, when the merchandise was bought, to 4.25 SR = 1 US dollar at December 31, 20XX+1 (i.e., the end of the reporting period). The translation of this item into the functional currency will necessitate an adjustment to reduce the carrying amount of the inventory to its net realizable value if this value when translated into the functional currency is lower than the carrying amount translated at the rate prevailing on the date of purchase of the merchandise.

Although the net realizable value, which in terms of Saudi riyals is 4,000,000 (SR), is higher than the carrying amount in Saudi riyals (i.e., 3,750,000 SR) when translated into the functional currency (i.e., US dollars) at the end of the reporting period, the net realizable value is lower than the carrying amount (translated into the functional currency at the exchange rate prevailing on the date of acquisition of the merchandise). Thus, on the financial statements of the foreign operation the inventory would not have to be adjusted. However, when the net realizable value is translated at the closing rate (which is 4.25 SR = 1 US dollar) into the functional currency, it will require the following adjustment:

1. Carrying amount translated at the exchange rate on September 15, 20XX (i.e., the date of acquisition) =  $\text{SR } 3,750,000 \div 3.75 = \$1,000,000$
2. Net realizable value translated at the closing rate =  $\text{SR } 4,000,000 \div 4.25 = \$941,176$
3. Adjustment needed =  $\$1,000,000 - \$941,176 = \$58,824$ .

Conversely, IAS 21 further stipulates that an adjustment that already exists on the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting entity. To illustrate this point, the facts of the example above are repeated, with some variation, below.



**Example**

All other factual details remaining the same as the preceding example, it is now assumed that the inventory, which is carried on the books of the foreign operation at Saudi riyals (SR) 3,750,000, instead has a net realizable value of SR 3,250,000 at year-end. Also assume that the indirect exchange rate fluctuated from SR 3.75 = 1 US dollar at the date of acquisition of the merchandise to SR 3.00 = 1 US dollar at the end of the reporting period.

Since in terms of Saudi riyals, the net realizable value at the end of the reporting period was lower than the carrying value of the inventory, an adjustment must have been made in the statement of financial position of the foreign operation (in Saudi riyals) to reduce the carrying amount to the lower of cost or net realizable value. In other words, a contra asset account (i.e., a lower of cost or NRV) representing the difference between the carrying amount (SR 3,750,000) and the net realizable value (SR 3,250,000) must have been created on the books of the foreign operation.

On translating the financial statements of the foreign operation into the functional currency, however, it is noted that due to the fluctuation of the exchange rates the net realizable value when converted to the functional currency ( $\text{SR } 3,250,000 \div 3.00 = \$1,083,333$ ) is no longer lower than the translated carrying value which is to be converted at the exchange rate prevailing on the date of acquisition of the merchandise ( $\text{SR } 3,750,000 \div 3.75 = \$1,000,000$ ).

Thus, a reversal of the adjustment (for lower of cost or NRV) is required on the financial statements of the reporting entity, upon translation of the financial statements of the foreign operation.

**Translation of Foreign Currency Transactions in Further Detail**

According to IAS 21, a foreign currency transaction is a transaction that is “denominated in or requires settlement in a foreign currency.” Denominated means that the amount to be received or paid is fixed in terms of the number of units of a particular foreign currency, regardless of changes in the exchange rate.

From the viewpoint of a US company, for instance, a foreign currency transaction results when it imports or exports goods or services to a foreign entity or makes a loan involving a foreign entity and agrees to settle the transaction in currency other than the US dollar (the presentation currency of the US company). In these situations, the US company has “crossed currencies” and directly assumes the risk of fluctuating exchange rates of the foreign currency in which the transaction is denominated. This risk may lead to recognition of foreign exchange differences in the profit or loss of the US company. Note that exchange differences can result only when the foreign currency transactions are denominated in a foreign currency.

When a US company imports or exports goods or services and the transaction is to be settled in US dollars, the US company will incur neither gain nor loss because it bears no risk due to exchange rate fluctuations. The following example illustrates the terminology and procedures applicable to the translation of foreign currency transactions.

Assume that a US company, an exporter, sells merchandise to a customer in Germany on December 1, 20XX, for €10,000. Receipt is due on January 31, 20XX+1, and the US company prepares financial statements on December 31, 20XX. At the transaction date (December 1, 20XX), the spot rate for immediate exchange of foreign currencies indicates that €1 is equivalent to \$1.18.

To find the US dollar equivalent of this transaction, the foreign currency amount, €10,000, is multiplied by \$1.18 to get \$11,800. At December 1, 20XX, the foreign currency transaction should be recorded by the US company in the following manner:

Accounts receivable—Germany	11,800	
Sales		11,800

The accounts receivable and sales are measured in US dollars at the transaction date using the spot rate at the time of the transaction. While the accounts receivable is measured and reported in US dollars, the receivable is denominated or fixed in euros.

Foreign exchange gains or losses may occur if the spot rate for euros changes between the transaction date and the date of settlement (January 31, 20XX+1). If financial statements are prepared between the transaction date and the settlement date, all receivables and payables that are denominated in a currency different than that in which payment will ultimately be received or paid (the euro) must be restated to reflect the spot rates in existence at the end of the reporting period.

Assume that on December 31, 20XX the spot rate for euros is €1 = \$1.20. This means that the €10,000 is now worth \$12,000 and that the accounts receivable denominated in euros should be increased by \$200. The following journal entry would be recorded as of December 31, 20XX:

Accounts receivable—Germany	200	
Foreign currency exchange difference		200

Note that the sales account, which was credited on the transaction date for \$11,800, is not affected by changes in the spot rate. This treatment exemplifies what may be called a two-transaction viewpoint. In other words, making the sale is the result of an operating decision, while bearing the risk of fluctuating spot rates is the result of a financing decision. Therefore, the amount determined as sales revenue at the transaction date should not be altered because of a financing decision to wait until January 31, 20XX+1 for payment of the account.

The risk of a foreign exchange transaction loss can be avoided either by demanding immediate payment on December 1 or by entering into a forward exchange contract to hedge the exposed asset (accounts receivable). The fact that the US company in the example did not act in either of these two ways is reflected by requiring the recognition of foreign currency exchange differences (transaction gains or losses) in its profit or loss (reported as financial or non-operating items) in the period during which the exchange rates changed.

On the settlement date (January 31, 20XX+1), assume that the spot rate is €1 = \$1.17. The receipt of €10,000 and their conversion into US dollars would be journalized in the following manner:

Foreign currency	11,700	
Foreign currency transaction loss	300	
Accounts receivable—Germany		12,000
Cash	5,100	
Foreign currency		5,100

The net effect of this foreign currency transaction was to receive \$11,700 from a sale that was measured originally at \$11,800. This realized net foreign currency transaction loss of

\$100 is reported on two income statements: a \$200 gain in 20XX and a \$300 loss in 20XX+1. The reporting of the gain or loss in two income statements causes a temporary difference between pre-tax accounting and taxable income. This results because the transaction loss of \$100 is not deductible until 20XX+1, the year the transaction was completed or settled. Accordingly, interperiod tax allocation is required for foreign currency transaction gains or losses.

## **DISCLOSURE**

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A number of disclosure requirements have been prescribed by IAS 21. Primarily, disclosure is required of the amounts of exchange differences included in profit or loss for the period, exchange differences that are included in the carrying amount of an asset, and those that are recognized in other comprehensive income.

When there is a change in classification of a foreign operation, disclosure is required as to the nature of the change, reason for the change, and the impact of the change on the current and each of the prior years presented. When the presentation currency is different from the currency of the country of domicile, the reason for this should be disclosed, and in case of any subsequent change in the presentation currency, the reason for making this change should also be disclosed. An entity should also disclose the method selected to translate goodwill and fair value adjustments arising on the acquisition of a foreign entity. Disclosure is encouraged of an entity's foreign currency risk management policy.

The following additional disclosures are required:

- When the functional currency is different from the currency of the country in which the entity is domiciled, the reason for using a different currency;
- The reason for any change in functional currency or presentation currency;
- When financial statements are presented in a currency other than the entity's functional currency, the reason for using a different presentation currency, and a description of the method used in the translation process;
- When financial statements are presented in a currency other than the functional currency, an entity should state the fact that the functional currency reflects the economic substance of underlying events and circumstances;
- When financial statements are presented in a currency other than the functional currency, and the functional currency is the currency of a hyperinflationary economy, an entity should disclose the closing exchange rates between functional currency and presentation currency existing at the end of each reporting period presented;
- When additional information not required by IFRS is displayed in financial statements and in a currency other than presentation currency, as a matter of convenience to certain users, an entity should:
  - Clearly identify such information as supplementary information;
  - Disclose the functional currency used to prepare the financial statements and the method of translation used to determine the supplementary information displayed;
  - Disclose the fact that the functional currency reflects the economic substance of the underlying events and circumstances of the entity and the supplementary information is displayed in another currency for convenience purposes only; and
  - Disclose the currency in which supplementary information is displayed.

## HEDGING

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### Hedging a Net Investment in a Foreign Operation or Foreign Currency Transaction

#### *Hedges of a net investment in a foreign operation*

While IAS 21 did not address hedge accounting for foreign currency items other than classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity, IAS 39 has established accounting requirements which largely parallel those for cash flow hedges. (Cash flow hedging is discussed in Chapter 24.) Specifically, IAS 39 states that the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is to be recognized in other comprehensive income, whereas the ineffective portion of the hedge is to be either recognized immediately in results of operations if the hedging instrument is a derivative instrument, or else reported in other comprehensive income if the instrument is not a derivative.

The gain or loss associated with an effective hedge is reported in other comprehensive income, similar to foreign currency translation gain or loss. In fact, if the hedge is fully effective (which is rarely achieved in practice, however) the hedging gain or loss will be equal in amount and opposite in sign to the translation loss or gain.

In the examples set forth earlier in this chapter which illustrated the accounting for a foreign (German) operation of a US company, the cumulative translation gain as of year-end 20XX was reported as \$635,000. If the US entity had been able to enter into a hedging transaction that was perfectly effective (which would most likely have involved a series of currency forward contracts), the net loss position on the hedging instrument as of that date would have been \$635,000. If this were reported in other comprehensive income and accumulated in shareholders' equity, as required under IAS 39 and revised IAS 1, it would have served to exactly offset the cumulative translation gain at that point in time.

It should be noted that under the translation methodology prescribed by IAS 21 the ability to precisely hedge the net (accounting) investment in the German subsidiary would have been very remote, since the cumulative translation gain or loss is determined by both the changes in exchange rates since the common share issuances of the subsidiary (which occurred at discrete points in time and thus could conceivably have been hedged), as well as the changes in the various periodic increments or decrements to retained earnings (which having occurred throughout the years of past operations, would involve a complex array of exchange rates, making hedging very difficult to achieve). As a practical matter, hedging the net investment in a foreign subsidiary would serve a very limited economic purpose at best. Such hedging is more often done to avoid the potentially embarrassing impact of changing exchange rates on the reported financial position and financial results of the parent company, which may be important to management, but rarely connotes real economic performance over a longer time horizon.

Notwithstanding the foregoing comments, it is possible for a foreign currency transaction to act as an economic hedge against a parent's net investment in a foreign entity if:

1. The transaction is designated as a hedge.
2. It is effective as a hedge.

To illustrate, assume that a US parent has a wholly owned British subsidiary which has net assets of £2 million. The US parent can borrow £2 million to hedge its net

investment in the British subsidiary. Assume further that the British pound is the functional currency and that the £2 million liability is denominated in pounds. Fluctuations in the exchange rate for pounds will have no net effect on the parent company's consolidated statement of financial position because increases (decreases) in the translation adjustments balance due to the translation of the net investment will be offset by decreases (increases) in this balance due to the adjustment of the liability denominated in pounds.

In 2008, the IFRS Interpretations Committee issued IFRIC Interpretation 16, *Hedges of a Net Investment in a Foreign Operation*, which came into effect for annual periods beginning on or after October 1, 2008, with earlier application permitted.

IFRIC 16 clarifies that an entity can hedge (the hedge item) up to 100% of the carrying amount of the net assets (net investment) of the foreign operation in the consolidated financial statements of the parent. In addition, as with other hedge relationships, an exposure to foreign currency risk cannot be hedged twice. This means that if the same foreign currency risk is nominally hedged by more than one parent entity within the group (a direct and an indirect parent entity), only one hedge relationship can qualify for hedge accounting.

IAS 39 does not require that the operating unit that is exposed to the risk being hedged hold the hedging instrument. IFRIC 16 clarifies that this requirement also applies to the hedge of the net investment in a foreign operation. The functional currency of the entity holding the instrument is irrelevant in determining effectiveness, and any entity within the group, regardless of its functional currency, can hold the hedging instrument.

IFRIC 16 originally had a statement that the hedging instrument could not be held by the foreign operation whose net investment was being hedged. *2009 Improvements to IFRS* removed restriction on the entity that holds the hedging instruments, effective for annual periods beginning on or after July 1, 2009, which basically means that even the hedged entity can hold the hedging instrument itself as long as the designation, documentation and effectiveness requirements of IAS 39, paragraph 88, that relate to a net investment hedge are satisfied.

### ***Hedges of foreign currency transactions***

It may be more important for managers to hedge specific foreign-currency-denominated transactions, such as merchandise sales or purchases which involve exposure for the time horizon over which the foreign-currency-denominated receivable or payable remains outstanding. For example, consider the illustration set forth earlier in this chapter which discussed the sale of merchandise by a US entity to a German customer, denominated in euros, with the receivable being due sometime after the sale. During the period the receivable remains pending, the creditor is at risk for currency exchange rate changes that might occur, leading to exchange rate gains or losses, depending on the direction the rates move. The following discussion sets forth the possible approach that could have been taken (and the accounting therefor) to reduce or eliminate this risk.

In the example, the US company could have entered into a forward exchange contract on December 1, 20XX, to sell €10,000 for a negotiated amount to a foreign exchange broker for future delivery on January 31, 20XX+1. Such a forward contract would be a hedge against the exposed asset position created by having an account receivable denominated in

euros. The negotiated rate referred to above is called a futures or forward rate. This instrument would qualify as a derivative under IAS 39.

In most cases, this futures rate is not identical to the spot rate at the date of the forward contract. The difference between the futures rate and the spot rate at the date of the forward contract is referred to as a discount or premium. Any discount or premium must be amortized over the term of the forward contract, generally on a straight-line basis. The amortization of discount or premium is reflected in a separate revenue or expense account, not as an addition or subtraction to the foreign currency transaction gain or loss amount. It is important to observe that under this treatment, no net foreign currency transaction gains or losses result if assets and liabilities denominated in foreign currency are completely hedged at the transaction date.

To illustrate a hedge of an exposed asset, consider the following additional information for the German transaction.

On December 1, 20XX, the US company entered into a forward exchange contract to sell €10,000 on January 31, 20XX+1, at \$1.14 per euro. The spot rate on December 1 is \$1.12 per euro. The journal entries that reflect the sale of goods and the forward exchange contract appear as follows:

<i>Sale transaction entries</i>		<i>Forward exchange contract entries (futures rate €1 = \$1.14)</i>	
12/1/14 (spot rate €1 = \$1.12)		Due from exchange broker (\$)	11,400
Accounts receivable	11,200	Due to exchange broker (€)	11,200
(€)—Germany			
Sales	11,200	Premium on forward contract	200
12/31/14 (spot rate €1 = \$1.15)		Foreign currency transaction loss	300
Accounts receivable	300	Due to exchange broker (€)	300
(€)—Germany			
Foreign currency transaction gain	300	Premium on forward contract	100
		Financial revenue (\$100 = \$200/2 months)	100
1/31/15 (spot rate €1 = \$1.17)			
Foreign currency	11,700	Due to exchange broker	11,500
Accounts receivable	11,500	Foreign currency transaction loss	200
(€)—Germany			
Foreign currency		Foreign currency	11,700
Foreign currency transaction gain	200		
		Cash	11,400
		Due from exchange broker	11,400
		Premium on forward contract	100
		Financial revenue	100

The following points should be noted from the entries above:

1. The net foreign currency transaction gain or loss is zero. The account “Due from exchange broker” is fixed in terms of US dollars, and this amount is not affected by changes in spot rates between the transaction and settlement dates. The account “Due to

exchange broker” is fixed or denominated in euros. The US company owes the exchange broker €10,000, and these must be delivered on January 31, 20XX+1. Because this liability is denominated in euros, its amount is determined by spot rates. Since spot rates change, this liability changes in amount equal to the changes in accounts receivable because both of the amounts are based on the same spot rates. These changes are reflected as foreign currency transaction gains and losses that net out to zero.

2. The premium on forward contract is fixed in terms of US dollars. This amount is amortized to a financial revenue account over the life of the forward contract on a straight-line basis.
3. The net effect of this transaction is that \$11,400 was received on January 31, 20XX+1, for a sale originally recorded at \$11,200. The \$200 difference was taken into income via amortization.

### Currency of Monetary Items Comprising Net Investment in Foreign Operations

Amendments made to IAS 21 in December 2005 clarified that monetary items (whether receivable or payable) between any subsidiary of the group and a foreign operation may form part of the group’s investment in that foreign operation. Thus, these monetary items can be denominated in a currency other than the functional currency of either the parent or the foreign operation itself, for exchange differences on these monetary items to be recognized in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation.

#### Example

Assume the following group structure: Parent, a French company, Eiffel SARL (Group Eiffel), has a functional currency of the euro. Parent company has a 100% direct interest in a US investment company, Freedom, Inc., which has a functional currency of the US dollar. Freedom, in turn, owns a British subsidiary, Royal Ltd. (100% ownership), which has a functional currency of the pound sterling. Freedom lends \$100,000 to Royal. The question is whether the loan can be accounted for as part of Group Eiffel’s net investment in Royal with any exchange differences recognized in other comprehensive income.

Under provisions of the 2003 version of IAS 21, the \$100,000 loan between Freedom and Royal could not be accounted for as part of Group Eiffel’s net investment, since the loan was made in a third currency, and not in the functional currency of the parent (the euro) or of the foreign subsidiary (£). As a result, any exchange differences on this loan would be reported in the consolidated profit or loss statement of Group Eiffel.

The results obtained under the 2003 version of IAS 21 struck many as not being entirely logical, and these concerns were dealt with in the 2005 amendment. This allows that exchange differences on loans such as in the foregoing example, can be recognized in other comprehensive income and in equity in the consolidated statement of financial position of reporting entities such as Group Eiffel. This change in accounting requirements allows many more funding structures to be accounted for as net investments in foreign operations. Thus, the accounting will no longer be dependent upon which of the group’s entities conducts a transaction with the foreign operation, nor will it be dependent upon the currency of the monetary items.

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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### Exemplum Reporting PLC Financial statements For the year ended 31 December 20XX

#### Accounting policy: Foreign currencies

##### Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of the entities within the group. Monetary items denominated in foreign currencies are retranslated at the exchange rates applying at the reporting date. Non-monetary items carried at fair value that are denominated in foreign currencies are retranslated at the rates prevailing at the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences are recognized in profit or loss in the period in which they arise except for:

- exchange differences on foreign currency borrowings which are regarded as adjustments to interest costs, where those interest costs qualify for capitalization to assets under construction;
- exchange differences on transactions entered into to hedge foreign currency risks (assuming all hedge accounting test are met); and
- exchange differences on loans to or from a foreign operation for which settlement is neither planned nor likely to occur and therefore forms part of the net investment in the foreign operation, which are recognized initially in other comprehensive income and reclassified from equity to profit or loss on disposal or partial disposal of the net investment.

##### Foreign operations

The functional currency of the parent company and the presentation currency of the consolidated financial statements is Pounds Sterling. The assets and liabilities of the Group's foreign operations are translated to Pounds Sterling using exchange rates at period end.

Income and expense items are translated at the average exchange rates for the period, unless exchange rates fluctuated significantly during that period, in which case the exchange rate on transaction date is used. Goodwill acquired in business combinations of a foreign operations are treated as assets and liabilities of that operation and translated at the closing rate.

Exchange differences are recognized in other comprehensive income and accumulated in a separate category of equity.

On the disposal of a foreign operation, the accumulated exchange differences of that operation, which is attributable to the Group are recognized in profit or loss.

## US GAAP COMPARISON

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There are very few differences between IFRS and US GAAP. I am not aware of any differences between IFRS and US GAAP in accounting for foreign currency other than (1) determining the functional currency, and (2) when the foreign sub resides in a highly inflationary country.

- Under US GAAP, the financial statements of a foreign subsidiary, which resides in a highly inflationary economy, are re-measured as if the parent's reporting currency were its functional currency.
- Under US GAAP, a number of indicators must be considered in determining the entity's functional currency. Those indicators not set up in a hierarchical structure as they are under IFRS



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## INTRODUCTION

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The accounting for financial instruments received a great deal of attention from the IFRS Foundation—being the subject of its two most voluminous and controversial standards—and continued attention is a certainty. The original intent, which was to address all matters of recognition, measurement, derecognition, presentation and disclosure in a single comprehensive standard, proved to be unworkable (as was also the case under US GAAP), and thus matters have been dealt with piecemeal. The first standard, IAS 32, which first became effective in 1996, has subsequently been revised and/or amended intermittently since then. It addressed only the presentation and disclosure requirements for financial instruments. The disclosure requirements set forth in IAS 32 were removed from that standard, effective 2007, and are now incorporated into IFRS 7, which also includes the financial institution disclosure requirements previously set forth by IAS 30. IFRS 7 is discussed in detail in this chapter.

The more intractable problems of recognition, measurement and derecognition were dealt with by IAS 39, which became mandatory in 2001. IAS 39 has been amended several times in the past, initially due to efforts by the IASB as it struggled to gain EU acceptance

for IFRS and more recently to respond to the challenges of the global financial crisis. IAS 39 was intended as only an interim standard; since it failed to comprehensively embrace fair value accounting for all financial assets and liabilities, which had been held out as the goal to which the IFRS Foundation was committed at the time. Fair value accounting, particularly for liabilities, was and remains a controversial topic. The global financial crisis also highlighted some potential weaknesses in the application of fair value accounting to financial liabilities.

Because of the complexity of IAS 39, a number of difficult implementation issues needed to be addressed, and in response the IFRS Foundation constituted an IAS 39 Implementation Guidance Committee (IGC). Several hundred questions and answers were published by this committee, and a compendium of guidance was produced in connection with the 2003 revisions to IAS 39 as well as incorporated into revised IAS 32 and IAS 39.

The global financial crisis of 2008 and 2009 underscored how closely the financial markets and the wider economy are interconnected, and the need for a commonly accepted high-quality set of accounting standards, particularly standards relating to financial instruments. Also it has shown how a lack of transparency can threaten the financial system as a whole, and therefore companies, especially financial institutions, need to provide more useful information to better communicate the risks flowing from transactions relating to financial instruments. The IASB realized that there was an urgent need to improve the accounting for financial instruments, since the current accounting rules have permitted numerous options and added what is now seen as having been unnecessary (or, at least, unwelcomed) complexity. In response to the global financial crisis, the IASB has embarked upon a number of projects that have ultimately amended the existing accounting standards on financial instruments through the issuance of IFRS 9, the new comprehensive accounting standard dealing with Financial Instruments which is effective for accounting periods beginning on or after 1 January 2018. IFRS 9 is discussed briefly below.

In this chapter, the overall requirements of IAS 32 and 39, and IFRS 7 will be set forth. In addition, this chapter will present detailed examples on a range of topics involving financial instruments that are derived from the most widespread and venerable practices in these areas, even if not codified in the IAS.

## **FUTURE DEVELOPMENTS AND A SUMMARY OF IFRS 9**

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### **Background to IFRS 9**

The IASB published the ED *Derecognition: Proposed Amendments to IAS 39 and IFRS 7* in March 2009, proposing to replace the existing guidance on derecognition of financial assets and financial liabilities and the related disclosures. This ED proposed a single approach to derecognition based on “control,” as opposed to the complex current requirements set forth under IAS 39, which combine elements of several derecognition concepts (e.g., risks and rewards, control and continuing involvement). The IASB decided to stop this project and only develop a standard on disclosure regarding derecognition; this project was completed in October 2010.

The project to replace IAS 39 was being conducted in three phases, which are:

- Classification and measurement;
- Impairment methodology; and
- Hedge accounting.

Phase I was completed and the IASB issued IFRS 9, *Financial Instruments*, in November 2009, dealing solely with the measurement and classification of financial assets and effective from January 2018. (The initial effective date was January 1, 2013, but due to delays in completing the rest of the phases of the project, the effective date has been moved out to 2018.) Phase II was deliberated and finalized in February 2014 and the related amendments were issued in July 2014. Phase III was finalized and published in November 2013 and an effective date of January 1, 2018 in the final complete version of IFRS issued in July 2014. In February 2014, the IASB also finalized on the amendments project it had undertaken since 2011. IFRS 9 will therefore replace IAS 39 from January 1, 2018.

Simplifying the requirements of IAS 39 was one of the objectives of the IASB when it embarked on the financial instruments project and it set out as one of its aims the requirement to reduce the number of categories of financial assets. As a result, IFRS 9 categorizes financial assets into just two categories, amortized cost and fair value. The “available-for-sale” and “held-to-maturity” categories currently included in IAS 39 do not form part of IFRS 9.

In short, IFRS 9 uses a principle-based model as compared to a rule-based model under IAS 39. It reduces the complexity revolving around recognition, reclassification and impairment models used.

### **Initial Recognition**

All financial instruments are initially measured at fair value, adjusted for transaction costs for instruments not carried at fair value. For financial instruments that will subsequently be measured at fair value, transaction costs are recognized in profit or loss.

### **Subsequent Recognition and Measurement**

**Debt instruments.** For a debt instrument to be classified as amortized cost, both of the following requirements must be applicable:

- It must be held within a business model whose objective is to hold assets in order to collect contractual cash flows up to maturity; and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

All other financial assets (other than equity instruments discussed below) are classified at fair value.

Within the fair value classification, fair value adjustments are recognized in profit or loss.

An entity may elect to designate on initial recognition a debt instrument financial asset at fair value if that would eliminate an accounting mismatch (the same option exists in IAS 39 and was carried forward from there) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases. IFRS 9 also introduces the concept of an expected loss model for measurement of impairments which is likely to create significant challenges for preparers of financial statements including financial institutions.

**Equity instruments.** Equity instruments must be measured at fair value in the statement of financial position. Changes in fair value are recognized in profit or loss unless an entity makes an irrevocable election upon initial recognition to recognize all gains or losses in other comprehensive income, with the exception of dividends which shall be recognized in profit or loss.

IFRS 9 no longer permits the measurement of unquoted equity instruments at cost, less provision for impairment. However, the standard recognizes that in limited circumstances, cost may represent a good estimate of fair value. The standard includes guidance and

examples for scenarios where cost may be considered the best estimate of fair value and also when it may not be the best estimate. It is therefore expected that more equity instruments will now be measured at fair value.

Subsequent to initial recognition an entity is required to reclassify a financial asset only if the business model within which it holds that asset changes. However, equity instruments designated at fair value through OCI cannot be subsequently reclassified.

Reclassifications are expected to be infrequent as the standard sets out examples of circumstances which do not represent a change in the business model, including a change in intention relating to a particular financial asset whether driven by significant market changes or not.

Any reclassification shall be applied prospectively from the date of reclassification, and the entity shall not restate any amounts with respect to the previous accounting. If an item is reclassified from amortized cost to fair value, any gain or loss or remeasurement to fair value shall be recognized in profit or loss. If an item is reclassified from fair value to amortized cost, its fair value at the date of reclassification shall become its new carrying amount.

**Financial liabilities.** There are two measurement categories for financial liabilities:

- Fair value through profit or loss;
- Amortized cost.

All financial liabilities that are held for trading are classified as fair value through profit or loss category. Any other financial liability is classified under the amortized cost category unless the option to designate at fair value through profit or loss is chosen.

The option to designate a financial liability as one held at fair value through profit or loss can be chosen when:

- Such treatment eliminates or significantly reduces inconsistencies related to measurement or recognition; or
- The financial liability is part of a group that is managed and evaluated on a fair value basis.

However, a financial liability can still be designated as fair value through profit or loss even if the above criteria are not met. IFRS 9 differs in its treatment of embedded derivatives that have a financial asset host compared with IAS 39. IFRS 9 requires that where the host contract itself is within the scope of it, then the classification and measurement requirements shall be applied to the entire contract and not to the separate components of it; in other words the contract may not be bifurcated between the host and the embedded derivative.

Embedded derivatives within contracts other than asset contracts are separated if the criteria for separation are met, which remain largely similar to IAS 39.

### **Hedge Accounting**

**Amendments to IFRS 9, *Financial Instruments* in November 2013.** IAS 39 hedge accounting requirements were found to be too arbitrary and rule based and they argued for a closer alignment with risk management. Hence this was replaced with hedge accounting requirements under IFRS 9. An example of this is the treatment of risk components. An example of this could be the LIBOR risk in a debt instrument. IFRS 9 eliminates this difference and as a principal based approach, IFRS 9 now looks at whether the risk component can be identified and measured and doesn't separate between types of items.

IFRS 9's new hedge accounting model enables entities to reflect better risk management activities in the financial statements.

## DEFINITIONS OF TERMS

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**Accounts receivable.** Amounts due from customers for goods or services provided in the normal course of business operations.

**Aging the accounts.** Procedure for the computation of the adjustment for uncollectible accounts receivable based on the length of time the end-of-period outstanding accounts have been unpaid.

**Amortized cost of financial asset or financial liability.** The amount at which the asset or liability was measured upon initial recognition, minus principal repayments, plus or minus the cumulative amortization of any premium or discount, and minus any write-down for impairment or uncollectibility.

**Assignment.** Formal procedure for collateralization of borrowings through the use of accounts receivable. It normally does not involve debtor notification.

**Available-for-sale financial assets.** Those non-derivative financial assets that are designated as available-for-sale or are not classified as (1) loans and receivables, (2) held-to-maturity investments, or (3) financial assets at fair value through profit or loss.

**Carrying amount (value).** The amount at which an asset is presented in the statement of financial position.

**Cash.** Cash on hand and demand deposits with banks or other financial institutions.

**Cash equivalents.** Short-term, highly liquid investments that are readily convertible to known amounts of cash which are subject to an insignificant risk of changes in value. Examples include Treasury bills, commercial paper and money market funds.

**Compound instrument.** An issued single financial instrument that contains both liability and equity features (e.g., convertible bond). In terms of IAS 32, “split accounting” is required for such instruments.

**Control.** The ability to direct the strategic financial and operating policies of an entity so as to obtain benefits from its activities.

**Credit risk.** The risk that a loss may occur from the failure of one party to a financial instrument to discharge an obligation according to the terms of a contract.

**Current assets.** An asset should be classified as current when it satisfies any of the following criteria: (1) it is expected to be realized in, or is intended for sale or consumption in, the entity’s normal operating cycle; (2) it is held primarily for the purpose of being traded; (3) it is expected to be realized within 12 months after the reporting period; or (4) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

**Derecognition.** Removal of a previously recognized financial asset or liability from an entity’s statement of financial position.

**Derivative.** A financial instrument or other contract with all three of the following characteristics: (1) its value changes in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying” or “cash” position); (2) it requires little or no initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and (3) it is settled at a future date.

**Effective interest method.** A method of calculating the amortized cost of a financial asset or a financial liability (or group of financial instruments) and of allocating the interest income or interest expense over the relevant period.

**Effective interest rate.** The rate that exactly discounts estimated future cash flows (receipts or payments) to the net carrying amount of the financial instrument through the expected life of this instrument (or a shorter period, when appropriate). In calculating the effective interest rate, an entity should estimate future cash flows after considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options), but without considering future credit losses. All fees and points paid or received between parties to the contract, transaction costs and other premium and discounts must also be included.

**Embedded derivative.** A component of a hybrid (combined) financial instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

**Equity instrument.** Any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities.

**Factoring.** Outright sale of accounts receivable to a third-party financing entity. The sale may be with or without recourse.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (See Chapter 25).

**Fair value through profit or loss.** An option in IAS 39 that permits an entity to irrevocably designate any financial asset or financial liability, but only upon its initial recognition, as one to be measured at fair value, with changes in fair value recognized in profit or loss.

**Financial asset.** Any asset that is:

1. Cash.
2. An equity instrument of another entity.
3. A contractual right.
  - a. To receive cash or another financial asset from another entity; or
  - b. To exchange financial instruments with another entity under conditions that are potentially favourable.
4. A contract that will be settled in the reporting entity's own equity instruments and is:
  - a. A non-derivative for which the entity is or may be obligated to receive a variable number of its own equity instruments; or
  - b. 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 (which excludes puttable financial instruments classified as equity and instruments that are themselves contracts for the future receipt or delivery of the entity's equity instruments).

**Financial assets (categories).** Include the following four principal categories (1) at fair value through profit or loss (held for trading, and those designated as at fair value through profit or loss [FVTPL] upon initial recognition); (2) available-for-sale; (3) held-to-maturity; and (4) loans and receivables.

**Financial asset or liability reported at fair value through profit or loss.** One which *either* is acquired or incurred for trading (i.e., is principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, or which is part of identified commonly managed financial instruments and for which there is a pattern of short-term profit-taking by the entity, or which is a derivative unless designated for, and effective as, a hedging

instrument) or upon initial recognition is designated for carrying at fair value through profit or loss.

**Fair value through profit or loss designation.** IAS 39 permits an entity to irrevocably designate any financial asset or financial liability, upon its initial recognition, as one to be measured at fair value, with changes in fair value recognized in profit or loss.

**Financial guarantee contract.** A contract that requires the issuer to make specified payments to reimburse the holder for losses incurred because a specified debtor failed to make payment when due based on the original or modified terms of a debt instrument.

**Financial instrument.** Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

**Financial liability.** Any liability that is:

1. A contractual obligation:
  - a. To deliver cash or another financial asset to another entity.
  - b. To exchange financial instruments with another entity under conditions that are potentially unfavourable to the entity.
2. A contract that will or may be settled in the entity's own equity instruments and is:
  - a. A non-derivative for which the entity is or may be obligated to deliver a variable number of its own equity instruments; or
  - b. 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 (which excludes puttable financial instruments classified as equity and instruments that are themselves contracts for the future receipt or delivery of the entity's equity instruments).

**Firm commitment.** A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

**Hedge effectiveness.** The degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

**Hedged item.** An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (1) exposes the entity to risk of changes in fair value or future cash flows, and (2) is designated as being hedged.

**Hedging.** Designating one or more hedging instruments such that the change in fair value or cash flows of the hedging instrument is an offset, in whole or part, to the change in fair value or cash flows of the hedged item. The objective is to ensure that the gain or loss on the hedging instrument is recognized in profit or loss in the same period that the hedged item affects profit or loss. Types of hedges are (1) fair value; (2) cash flow; and (3) net investment in a foreign operation.

**Hedging instrument.** For hedge accounting purposes, a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

**Held-to-maturity investments.** Non-derivative financial assets with fixed or determinable payments and fixed maturities, that the entity has the positive intent and ability to hold to maturity, except for (1) those at fair value through profit or loss; (2) those designated as

available-for-sale; and (3) loans and receivables. An entity should not classify any financial assets as held-to-maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount (in relation to the total amount of held-to-maturity investments) of held-to-maturity investments before maturity (the so-called “tainting” rules).

**Liquidity risk.** The risk that an entity may encounter difficulty in meeting obligations associated with financial liabilities.

**Loans and receivables.** Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than (1) those at fair value through profit or loss; (2) those designated as available-for-sale; and (3) those which the holder may not recover substantially all of its initial investment (other than because of credit deterioration), which should be classified as available-for-sale.

**Market risk.** The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices; it comprised three types of risk: currency risk, interest rate risk and other price risk.

**Market value.** Amount obtainable from a sale, or payable on acquisition, of a financial instrument in an active market.

**Marketable equity instruments.** Instruments representing actual ownership interest, or the rights to buy or sell such interests, that are actively traded or listed on a national securities exchange.

**Monetary financial assets and financial liabilities.** Financial assets and financial liabilities to be received or paid in fixed or determinable amounts of currency.

**Net realizable value.** The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

**Operating cycle.** Average time between the acquisition of materials or services and the final cash realization from the sale of products or services.

**Other price risk.** The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

**Percentage-of-sales method.** Procedure for computing the adjustment for uncollectible accounts receivable based on the historical relationship between bad debts and gross credit sales.

**Pledging.** Process of using an asset as collateral for borrowings. It generally refers to borrowings secured by accounts receivable.

**Puttable instrument.** A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset. It can also be automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

**Realized gain (loss).** Difference between the cost or adjusted cost of a marketable security and the net selling price realized by the seller, which is to be included in the determination of profit or loss in the period of the sale.

**Recourse.** Right of the transferee (factor) of accounts receivable to seek recovery for an uncollectible account from the transferor. It is often limited to specific conditions.

**Repurchase agreement.** An agreement to transfer a financial asset to another party in exchange for cash or other considerations, with a concurrent obligation to reacquire the asset at a future date.



**Securitization.** The process whereby financial assets are transformed into securities.

**Short-term investments.** Financial instruments or other assets acquired with excess cash, having ready marketability and intended by management to be liquidated, if necessary, within the current operating cycle.

**Transaction costs.** Incremental costs directly attributable to the acquisition or disposal of a financial asset or liability.

## DISCUSSION OF CERTAIN CONCEPTS

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### Cash

Common practice is to define cash as including currency on hand, as well as current and other accounts maintained with banks. However, cash that is not available for immediate use (restricted cash balances) is normally given separate disclosure to prevent misleading the users of the financial statements.

IAS 1 requires assets and liabilities be presented in the statement of financial position using the current and non-current classification, unless presentation in the order of liquidity is deemed more reliable and relevant.

If a classified statement of financial position is presented, cash which is restricted and not available for use within one year of the reporting period should be included in non-current assets.

For a current asset classification to be warranted, it must furthermore be management's intention that the cash be available for current purposes. For example, cash in a demand deposit account, being held specifically for the retirement of long-term debts not maturing currently, should be excluded from current assets and shown as a non-current asset. This would apply only if management's intention was clear; otherwise it would not be necessary to segregate from the general cash account the funds that presumably will be needed for a scheduled debt retirement, as those funds could presumably be obtained from alternative sources, including new borrowings.

It has become common for the caption "cash and cash equivalents" to appear in the statement of financial position. This term includes other forms of near-cash items as well as demand deposits and liquid, short-term instruments.

IAS 7 defines cash equivalents as short-term, highly liquid investments, readily convertible into known amounts of cash that are subject to an insignificant risk of changes in value. The reasonable, albeit arbitrary, limit of three months as per the definitions in IAS 7 is placed on the maturity dates of any instruments acquired to be part of cash equivalents. Equity investments are excluded from cash equivalents unless they are in substance cash equivalents, e.g., preference shares acquired within a short period of their maturity date. (This is the same limit applied by the US standard on cash flow statements, FAS 95.)

Compensating balances are cash amounts that are not immediately accessible by the owner. Pursuant to borrowing arrangements with lenders, an entity will often be required to maintain a minimum amount of cash on deposit (as a "compensating balance"). While stated to provide greater security for the loan, the actual purpose of this balance is to increase the yield on the loan to the lender. Since most organizations will need to maintain a certain working balance in their cash accounts simply to handle routine transactions and to cushion against unforeseen fluctuations in the demand for cash, borrowers often find compensating balance arrangements not objectionable and may well have sufficient

liquidity to maintain these with little hardship being incurred. They may even be viewed as comprising “rotating” normal cash balances that are flowing into and out of the bank on a regular basis.

Notwithstanding how these are viewed by the debtor, however, the fact is that compensating balances are not available for unrestricted use, and penalties will result if they are withdrawn rather than being left intact, as called for under the arrangement. Therefore, the portion of an entity’s cash account that is held as a compensating balance must be segregated and shown as a non-current asset if the related borrowings are non-current liabilities. If the borrowings are current liabilities, it is acceptable to show the compensating balance as a separately captioned current asset, but under no circumstances should these be included in the caption “cash.”

In some jurisdictions, certain cash deposits held by banks, such as savings accounts or corporate time deposits, are subject to terms and conditions that might prevent immediate withdrawals. While not always exercised, these rights permit a delay in honouring withdrawal requests for a stated period of time, such as seven days or one month. These rules were instituted to discourage panic withdrawals and to give the depository institution adequate time to liquidate investments in an orderly fashion. Cash in savings accounts subject to a statutory notification requirement and cash in certificates of deposit maturing during the current operating cycle or within one year may be included as current assets, but as with compensating balances, should be separately captioned in the statement of financial position or the notes to the financial statements to avoid the misleading implication that these funds are available immediately upon demand. Typically, such items will be included in the short-term investments caption, but these could be separately labelled as time deposits or restricted cash deposits.

Petty cash and other imprest cash accounts are usually presented in financial statements with other cash accounts. Due to materiality considerations, under current rules these need not be set forth in a separate caption unless so desired.

Example of the disclosure in the notes to the financial statements

	<b>Note x, Cash and cash equivalents</b>	
	20XX	20XX-1
<b>Non-current</b>		
Restricted term deposits	xx	xx
<b>Current</b>		
Cash at bank and in hand	xx	xx
Term deposits	xx	xx
Total cash at bank and in hand	<u>xx</u>	<u>xx</u>

Restricted term deposits relate to term deposits used for securing borrowings amounting to XX. These term deposits are not available for use in day-to-day operations of the company.

For the purposes of the cash flow statement, cash and cash equivalents comprise the following:

Total cash and bank in hand	20XX XX	20XX-1 XX
Less:		
Restricted term deposits	(x)	(x)
Bank overdrafts (note x)	(x)	(x)
Total cash and cash equivalents	<u>xx</u>	<u>xx</u>

## Receivables

Receivables include trade receivables, which are amounts due from customers for goods sold and/or services performed in the normal course of business, as well as such other categories of receivables such as notes receivable, trade acceptances, third-party instruments, deposits and amounts due from officers, shareholders, employees or affiliated companies.

Notes receivable are formalized obligations evidenced by written promissory notes. The latter categories of receivables generally arise from cash advances but could develop from sales of merchandise or the provision of services. The basic nature of amounts due from trade customers is often different from that of balances receivable from related parties, such as employees or shareholders. Thus, the general practice is to insist that the various classes of receivables be identified separately either on the face of the statement of financial position or in the notes. Revised IAS 1 does not explicitly require such presentation.

IAS 39 addresses recognition and measurement of receivables. In addition, a number of international standards allude to the accounting for receivables. For example, IAS 18, *Revenue Recognition*, addresses the timing of revenue recognition, which implicitly addresses the timing of recognition of the resulting receivables.

IAS 39 requires that receivables are initially recognized at the fair value and subsequently measured at amortized costs including the effect of impairment. Entities use a variety of techniques to estimate the possible level of impairment and write-offs, all of which should aim to measure receivables at an amount that takes due consideration of credit losses that have occurred as at the reporting date. This requires significant elements of estimation including estimating expected losses rates, as well as when any expected cash inflows will occur, which may have a significant impact as the expected cash flows are discounted to present value at the original effective interest rate.

## Pledging, Assigning and Factoring Receivables

An organization can alter the timing of cash flows resulting from sales to its customers by using its accounts receivable as collateral for borrowings or by selling the receivables outright. A wide variety of arrangements can be structured by the borrower and lender, but the most common are pledging, assignment and factoring. The IFRSs do not offer specific accounting guidance on these assorted types of arrangements, although the derecognition rules of IAS 39 generally apply to these as well as other financial instruments of the reporting entity.

### *Pledging of receivables*

Pledging is an agreement whereby accounts receivable are used as collateral for loans. Generally, the lender has limited rights to inspect the borrower's records to achieve assurance that the receivables do exist. The customers whose accounts have been pledged are not aware of this event, and their payments are still remitted to the original obligee. The pledged accounts merely serve as security to the lender, giving comfort that sufficient assets exist that will generate cash flows adequate in amount and timing to repay the debt. However, the debt is paid by the borrower whether or not the pledged receivables are collected and whether or not the pattern of such collections matches the payments due on the debt.

The only accounting issue relating to pledging is that of adequate disclosure. The accounts receivable, which remain assets of the borrowing entity, continue to be shown as current assets in its financial statements but must be identified as having been pledged.

It is common practice to include the disclosure regarding the pledging of receivables in the notes to the financial statements and is required in terms of IFRS 7.

### ***Assignment of receivables***

The assignment of accounts receivable is a more formalized transfer of the asset to the lending institution. The lender will make an investigation of the specific receivables that are being proposed for assignment and will approve those that are deemed to be worthy as collateral. Customers are not usually aware that their accounts have been assigned and they continue to forward their payments to the original obligee. In some cases, the assignment agreement requires that collection proceeds be delivered to the lender immediately. The borrower is, however, the primary obligor and is required to make timely payment on the debt whether or not the receivables are collected as anticipated. The borrowing is with recourse, and the general credit of the borrower is pledged to the payment of the debt.

Since the lender knows that not all the receivables will be collected on a timely basis by the borrower, only a fraction of the face value of the receivables will be advanced as a loan to the borrower. Typically, this amount ranges from 70% to 90%, depending on the credit history and collection experience of the borrower.

Assigned accounts receivable remain the assets of the borrower and continue to be presented in its financial statements, with appropriate disclosure of the assignment similar to that for pledged receivables. Prepaid finance charges would be debited to a prepaid expense account and amortized to expense over the period to which the charges apply.

### ***Factoring of receivables***

This category of financing is the most significant in terms of accounting implications. Factoring traditionally has involved the outright sale of receivables to a financing institution known as a factor. These arrangements involve:

- Notification to the customer to forward future payments to the factor; and
- The transfer of receivables without recourse. The factor assumes the risk of an inability to collect. Thus, once a factoring arrangement is completed, the entity has no further involvement with the accounts except for a return of merchandise.

The classical variety of factoring provides two financial services to the business:

- It permits the entity to obtain cash earlier; and
- The risk of bad debts is transferred to the factor. The factor is compensated for each of the services. Interest is charged based on the anticipated length of time between the date the factoring is consummated and the expected collection date of the receivables sold, and a fee is charged based on the factor's anticipated bad debt losses.

Some companies continue to factor receivables as a means of transferring the risk of bad debts but leave the cash on deposit with the factor until the weighted-average due date of the receivables, thereby avoiding interest payments. This arrangement is still referred to as factoring, since the customer receivables have been sold. However, the borrowing entity does not receive cash but instead has created a new receivable, usually captioned "due from factor." In contrast to the original customer receivables, this receivable is essentially riskless and will be presented in the statement of financial position without a deduction for an estimated uncollectible amount.

Merchandise returns will normally be the responsibility of the original vendor, who must then make the appropriate settlement with the factor. To protect against the possibility of merchandise returns that diminish the total of receivables to be collected, very often a factoring arrangement will not advance the full amount of the factored receivables (less any interest and factoring fee deductions). Rather, the factor will retain a certain fraction of the total proceeds relating to the portion of sales that are anticipated to be returned by customers. This sum is known as the factor's *holdback*. When merchandise is returned to the borrower, an entry is made offsetting the receivable from the factor. At the end of the return privilege period, any remaining holdback will become due and payable to the borrower.

**Examples of journal entries to be made by the borrower in a factoring situation**

1. Thirsty Corp. on July 1, 20XX, enters into an agreement with Rich Company to sell a group of its receivables without recourse. A total face value amounting to €200,000 of accounts receivable (against which a 5% allowance had been recorded) is involved. The factor will charge 20% interest computed on the (weighted) average time to maturity of the receivables of 36 days plus a 3% fee. A 5% holdback will also be retained.
2. Thirsty's customers return for credit €4,800 of merchandise.
3. The customer return privilege period expires and the remaining holdback is paid to the transferor.

The entries required are as follows:

1.	Cash	180,055	
	Allowance for bad debts ( $€200,000 \times .5\%$ )	10,000	
	Interest expense (or prepaid) ( $€200,000 \times 20\% \times 36/365$ )	3,945	
	Factoring fee ( $€200,000 \times 3\%$ )	6,000	
	Factor's holdback receivable ( $€200,000 \times 5\%$ )	10,000	
	Bad debts expense		10,000
	Accounts receivable		200,000
	(Alternatively, the interest and factor's fee can be combined into a €9,945 charge to loss on sale (factoring) of receivables.)		
2.	Sales returns and allowances	4,800	
	Factor's holdback receivable		4,800
3.	Cash	5,200	
	Factor's holdback receivable		5,200

**Transfers of Receivables with Recourse**

In recent decades, a variant on traditional receivables factoring has become popular. This variation has been called factoring with recourse, the terms of which suggest somewhat of a compromise between true factoring and the assignment of receivables. Accounting practice has varied considerably because of the hybrid nature of these transactions, and a strong argument can be made, in fact, that the factoring with recourse is nothing more than the assignment of receivables, and that the proper accounting (as discussed above) is to present this as a secured borrowing, not as a sale of the receivables. While "factoring with recourse" was previously held to qualify for derecognition by the transferor, this is now seen to be inconsistent with the derecognition rules of IAS 39, due to the nominal transferor's continuing involvement and retention of risk.

## IAS 32: FINANCIAL INSTRUMENTS—PRESENTATION

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When first issued in 1995, IAS 32 was an important achievement for several reasons. It represented a commitment to a strict “substance over form” approach. The substance of a financial instrument, rather than its legal form, governs its classification on the statement of financial position. The most significant accomplishment, perhaps, was the requirement that disparate elements of compound financial instruments be separately presented in the statement of financial position.

The objective of IAS 32 is to provide principles for:

- Presenting financial instruments as liabilities or equity.
- Offsetting financial assets and financial liabilities.
- Classifying financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments (and classification of related interest, dividends, losses and gains).

Scope exceptions in IAS 32, IAS 39 and IFRS 7 include:

- Interests in subsidiaries, associates and joint ventures (IFRS 10, IAS 27 and IAS 28).
- Rights and obligations under which IAS 17 applies.
- Recognition of certain provisions under IAS 37.
- Employers’ rights and obligations under employee benefit plans (IAS 19).
- Insurance contracts, except for certain financial guarantee contracts (IFRS 4).
- Acquirer accounting for contingent consideration contracts in a business combination (IFRS 3).
- Financial instruments, contracts, and obligations under share-based payment transactions (IFRS 2).

### Issues Addressed by IAS 32

#### *Distinguishing liabilities from equity*

It sometimes happens that financial instruments of a given issuer may have attributes of both liabilities and equity. A compound instrument is a single financial instrument that contains both a liability and an equity element (e.g., convertible bond). From a financial reporting perspective, the central issue is whether to account for these “compound” instruments as *either* liabilities or equity *in total*, or to disaggregate them into both liabilities and equity instruments. In 2003 the FASB adopted FAS 150 (now replaced by ASC 480), which requires debt-like instruments to be classified as liabilities. However, due to strong opposition, implementation of certain aspects of that standard have been delayed, some indefinitely. The IFRS Foundation, however, resolutely dealt with this matter.

Under the provisions of IAS 32, the issuer of a financial instrument must classify it, or its component parts, in accordance with the substance of the respective contractual arrangement. Thus, it is quite clear that under IFRS, when the instrument gives rise to an obligation on the part of the issuer to deliver cash or another financial asset or to exchange financial instruments on potentially unfavourable terms, it is to be classified as a liability, not as equity. Mandatorily redeemable preference shares and preference shares issued with put options (options that can be exercised by the holder, potentially requiring the issuer to redeem the shares at agreed-upon prices) must, under this definition, be presented as liabilities.

The presentation of ordinary shares subject to a buyout agreement with the entity's shareholders is less clear. Closely held entities frequently structure *buy-sell agreements* with each shareholder, which require that upon the occurrence of defined events, such as a shareholder's retirement or death, the entity will be required to redeem the former shareholder's ownership interest at a defined or determinable price, such as fair or book value. The practical effect of buy-sell agreements is that all but the final shareholder will eventually become creditors; the last to retire or die will be, by default, the residual owner of the business, since the entity will be unable to redeem that holder's shares unless a new investor enters the picture. IAS 32 does not address this type of situation explicitly, although circumstances of this sort are clearly alluded to by the standard, which notes that "if a financial instrument labelled as a share gives the holder an option to require redemption upon the occurrence of a future event that is highly likely to occur, classification as a financial liability on initial recognition reflects the substance of the instrument." Notwithstanding this guidance, entities can be expected to be quite reluctant to reclassify the majority of shareholders' equity as debt in cases such as that described above.

IAS 32 goes beyond the formal terms of a financial instrument in seeking to determine whether it might be a liability. Thus, for example, under IAS 32, prior to the amendments made in 2008 (see immediately following paragraphs), a preference share which has mandatory redemption provisions, or which is "puttable" by the holder, was to be classified and accounted for as a liability upon its original issuance.

According to IAS 32, before revision, if an issuer was subject to a requirement that it pay cash or deliver another financial asset in return for redeeming or repurchasing a financial instrument, the instrument was to be classified as a financial liability. This was consistent with the long-held definition of a liability as an obligation to make a future payment as a consequence of a past action. As interpreted, this held even if the amount payable was equal to the holder's interest in the net assets of the issuer, or if the amount would only become payable at liquidation and liquidation was deemed to be certain because, for example, a fixed liquidation date for the entity was defined.

Some believed that this mandate resulted in liability treatment even where it might be unwarranted, with the result that otherwise financially healthy entities could be forced to report negative equity. This would occur, for example, where the total amount payable would equal the *market value* of the whole entity, which could well exceed the *accounting net assets* of the entity. Alternatively, where liquidation is certain or is at the option of the holder, instruments that represent the last residual interest in the entity may be recognized as financial liabilities even when the instruments have characteristics similar to equity, since not all equity can be redeemed if the entity is to be considered a going concern.

To deal with these perceived anomalies, in February 2008, amendments to IAS 32 were adopted, to provide a "short-term, limited scope amendment" to obviate these unwelcome outcomes. IASB concluded that some puttable financial instruments and financial instruments that impose on the issuer an obligation to deliver a pro rata share of net assets of the entity only on liquidation are equity, and thus should not be presented as liabilities. The amendments are very particularized and cannot be analogized to any other fact patterns, and very extensive detailed criteria need to be met in order to present these instruments as equity.

The revised IAS 32 clarifies that an issuer can classify a financial instrument as equity only if both conditions below are met:

1. The instrument includes no contractual obligations (a) to deliver cash or another financial asset, or (b) to exchange financial assets or financial liabilities with another entity under potentially unfavourable conditions to the issuer.
2. If the instrument will or may be settled in the issuer's own shares (equity instruments), it is a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own shares, or a derivative that will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own shares. (For this purpose, the issuer's own shares do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own shares.)

**Example of classification of contracts settled in an entity's own equity instruments (IAS 32)**

<u>Derivative contract</u>	<u>Gross physical settlement*</u>	<u>Net settlement (net cash or net shares)</u>	<u>Issuer/counterparty right of gross or net settlement</u>
Purchased or written call	Equity	Derivative	Derivative
Purchased put	Equity	Derivative	Derivative
Written put	Liability	Derivative	Derivative/Liability
Forward to buy	Liability	Derivative	Derivative/Liability
Forward to sell	Liability	Derivative	Derivative

\*Fixed number of shares for fixed amount of cash/financial asset.

### ***Puttable financial instruments***

Under revised IAS 32, puttable financial instruments are now to be presented as equity, but only if *all* of the following criteria are met:

1. The holder is entitled to a pro rata share of the entity's net assets on liquidation;
2. The instrument is in the class of instruments that is the most subordinate and all instruments in that class have identical features;
3. The instrument has no other characteristics that would meet the definition of a financial liability; and
4. The total expected cash flows attributable to the instrument over its life are based substantially on either (1) profit or loss; (2) the change in the recognized net assets; or (3) the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of the instrument itself). Profit or loss or change in recognized net assets for this purpose is as measured in accordance with relevant IFRS.

In addition to the above criteria, the reporting entity is permitted to have no other instrument with terms equivalent to 4. above that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments. A financial instrument that imposes an obligation to deliver a pro rata share of the net assets of an entity on liquidation should meet the first two criteria above to be classified as equity.

Based on these new requirements, it is clear that certain classifications of financial instruments issued by the reporting entity will now have to be changed. Shares that are puttable throughout their lives at fair value, that are also the most subordinate of the instruments issued by the reporting entity, and which do not contain any other obligation, and which have only discretionary (i.e., non-fixed) dividends based on profits of the issuer,



will now be deemed equity, although classed as liabilities under IAS 32 prior to this amendment.

By contrast, shares that are puttable at fair value, but which are *not* the most subordinate class of instrument issued, must still be classified as liabilities under revised IAS 32.

Shares that are puttable at fair value only on liquidation, and that are also the most subordinate class of instrument, but which specify a fixed non-discretionary dividend obligation, will now be treated as compound financial instruments (that is, as being part equity, part liability). Rules governing the allocation of proceeds among elements of compound instruments are discussed in a subsequent section of this chapter and also later in this publication.

Finally, shares that are puttable at fair value only on liquidation, and that are also part of the most subordinate class of instruments issued, but are entitled to fixed, discretionary dividends, and do not contain any other obligation, are now to be deemed part of equity, and not liabilities.

If any of these instruments have been issued by a subsidiary (rather than by the reporting parent entity), and are held by non-controlling parties, these must be reported as liabilities in the consolidated financial statements. Thus, certain equity of the subsidiary, in its separate financial statements, to the extent held by non-controlling interests, would have to be reclassified to liabilities in the consolidation process.

### IAS 32—Presentation Examples

<u>Financial instrument</u>	<u>Presentation</u>
Common shares	Equity
Mandatorily redeemable instruments	Liabilities*
Instruments redeemable at the option of the holder	Liabilities*
Puttable instruments	Liabilities*
Obligation to issue shares worth a fixed or determinable amount	Liabilities
Perpetual debt	Liabilities
Instruments with contingent settlement provisions	Liabilities (unless non-substantive provision)
Convertible debt	Potentially compound instrument

\*With certain exceptions

### *Interests in cooperatives*

IFRIC 2, *Members' Shares in Cooperative Entities and Similar Instruments*, states that the contractual right of the holder of a financial instrument (including members' shares in cooperative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity, including relevant local laws, regulations, and the entity's governing charter in effect at the date of classification.

Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares or if redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. However, if redemption is prohibited only if defined conditions—such as liquidity constraints—are met (or are not met), members' shares are not equity.

## Convertible Debt Instruments

Bonds are frequently issued with the right to convert them into ordinary shares of the company at the holder's option when certain terms and conditions are met (i.e., a target market price is reached). Convertible debt is used for two reasons. First, when a specific amount of funds is needed, convertible debt often allows fewer shares to be issued (assuming that conversion ultimately occurs) than if the funds were raised by directly issuing the shares. Thus, less dilution is suffered by the other shareholders. Second, the conversion feature allows debt to be issued at a lower interest rate and with fewer restrictive covenants than if the debt were issued without it. That is because the bondholders are receiving the benefit of the conversion feature in lieu of higher current interest returns.

This dual nature of debt and equity, however, creates a question as to whether the equity element should receive separate recognition. Support for separate treatment is based on the assumption that this equity element has economic value. Since the convertible feature tends to lower the rate of interest, it can easily be argued that a portion of the proceeds should be allocated to this equity feature. On the other hand, a case can be made that the debt and equity elements are inseparable, and thus that the instrument is either all debt or all equity. IFRS had not previously addressed this matter directly, although the focus of the *IASB Framework* on "true and fair presentation" could be said to support the notion that the proceeds of a convertible debt offering be allocated between debt and equity accounts. The promulgation of IAS 32 resulted in the defining of convertible bonds (among other instruments) as being compound financial instruments, the component parts of which must be classified according to their separate characteristics.

### *Features of convertible debt instruments*

Revised IAS 32 addresses the accounting for compound financial instruments from the perspective of issuers. Convertible debt probably accounts for most of the compound instruments that will be of concern to those responsible for financial reporting. IAS 32 requires the issuer of such a financial instrument to present the liability component and the equity component separately in the statement of financial position. Allocation of proceeds between liability and equity proceeds as follows:

1. Upon initial recognition, the fair value of the liability component of compound (convertible) debt instruments is computed as the present value of the contractual stream of future cash flows, discounted at the rate of interest applied at inception by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but absent the conversion option. For example, if a 5% interest-bearing convertible bond would have commanded an 8% yield if issued without the conversion feature, the contractual cash flows are to be discounted at 8% in order to calculate the fair value of the unconditional debt component of the compound instrument.
2. The equity portion of the compound instrument is actually an embedded option to convert the liability into equity of the issuer. The fair value of the option is determined by time value and by the intrinsic value, if there is any. This option has value on initial recognition even when it is out of the money.

The issuance proceeds from convertible debt should be assigned to the components as described above.

Convertible debt also has its disadvantages. If the share price increases significantly after the debt is issued, the issuer would have been better off simply by issuing the share. Additionally, if the price of the share does not reach the conversion price, the debt will never be converted (a condition known as overhanging debt).

### ***Classification of compound instruments***

Compound instruments are those which are sold or acquired jointly, but which provide the holder with more than a single economic interest in the issuing entity. For example, a bond sold with share purchase warrants provides the holder with an unconditional promise to pay (the bond, which carries a rate of interest and a fixed maturity date) plus a right to acquire the issuer's shares (the warrant, which may be for common or preferred shares, at either a fixed price per share or a price based on some formula, such as a price that increases over time). In some cases, one or more of the component parts of the compound instrument may be financial derivatives, as a share purchase warrant would be. In other instances, each element might be a traditional, non-derivative instrument, as would be the case when a debenture is issued with common shares as a unit offering.

The accounting issue that is most obviously associated with compound instruments is how to allocate price or proceeds to the constituent elements. This becomes most important when the compound instrument consists of parts that are both liabilities and equity items. Proper classification of the elements is vital to accurate financial reporting, affecting potentially such matters as debt covenant compliance (if the debt-to-equity ratio, for example, is a covenant to be met by the debtor entity). Under IFRS, there is no mezzanine equity section as is sometimes observed under US GAAP and, for example, redeemable shares, including contingently redeemable shares, are classified as liabilities (exceptions: redeemable only at liquidation, redemption option not genuine or certain puttable instruments representing the most residual interest in the entity).

IAS 32, revised, requires that fair value be ascertained and then allocated to the liability components, with only the residual amount being assigned to equity. This position has been taken in order to be fully consistent with the definition of equity as instruments that evidence only a residual interest in the assets of an entity, after satisfying all of its liabilities.

If the compound instruments include a derivative element (e.g., a put option), the value of those features, to the extent they are embedded in the compound financial instrument other than the equity component, is to be included in the liability component.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. In other words, there can be no "day one" gains from issuing financial instruments.

#### **Example of accounting by issuer of compound instrument**

To illustrate the allocation of proceeds in a compound instrument situation, assume these facts.

1. 5,000 convertible bonds are issued by Needy Company on January 1, 20XX. The bonds are due December 31, 20XX+3.
2. Issuance price is par (€1,000 per bond); total issuance proceeds are €5,000,000.
3. Interest is due in arrears, semi-annually, at a nominal rate of 5%.
4. Each (€1,000 face amount) bond is convertible into 150 ordinary shares of Needy Company.
5. At issuance date, similar, non-convertible debt must yield 8%.

**Required residual value method.** Under the provisions of revised IAS 32, the issuer of compound financial instruments must assign full fair value to the portion that is to be classified as a liability, with only the residual value being allocated to the equity component. The computation for the above fact situation would be as follows:

1. Use the reference discount rate, 8%, to compute the market value of straight debt carrying a 5% yield:

PV of €5,000,000 due in 4 years, discounted at 8%	€3,653,451
PV of semi-annual payments of €125,000 for 8 periods, discounted at 8%	<u>841,593</u>
Total	<u><b>€4,495,044</b></u>

2. Compute the amount allocable to the conversion feature:

Total proceeds from issuance of compound instrument	€5,000,000
Value allocable to debt	<u>4,495,044</u>
Residual value allocable to equity component	<u><b>€504,956</b></u>

Thus, Needy Company received €4,495,044 in consideration of the actual debt being issued, plus a further €504,956 for the conversion feature, which is a call option on the underlying ordinary share of the issuer. The entry to record this would be:

Cash	5,000,000	Dr	
Discount on bonds payable	504,956	Dr	
Bonds payable			5,000,000 Cr
Paid-in capital—bond conversion option			504,956 Cr

The bond discount would be amortized as additional interest over the term of the debt.

#### Example of accounting by acquirer of compound instrument

From the perspective of the acquirer, compound financial instruments will often be seen as containing an embedded derivative—for example, a put option or a conversion feature of a debt instrument being held for an investment. This may be required to be valued and accounted for separately (which does not necessarily imply separate presentation in the financial statements, however). In terms of IAS 39, separate accounting is necessary if, and only if, the economic characteristics and risks of the embedded derivative are not closely related to the host contract; a separate instrument with the same terms would meet the definition of a derivative; and the combined instrument is not to be measured at fair value with changes included in profit or loss (i.e., it is neither held for trading nor subject to the “fair value option” election).

To illustrate the allocation of purchase cost in a compound financial asset situation, assume these facts:

1. 500 convertible Needy Company bonds are acquired by Investor Corp. January 1, 20XX. The bonds are due December 31, 20XX+3.
2. The purchase price is par (€1,000 per bond); total cost is thus €500,000.
3. Interest is due in arrears, semi-annually, at a nominal rate of 5%.
4. Each bond is convertible into 150 ordinary shares of the issuer.
5. At purchase date, similar, non-convertible debt issued by borrowers having the same credit rating as Needy Company yield 8%.
6. At purchase date, Needy Company common shares are trading at €5, and dividends over the next 4 years are expected to be €0.20 per share per year.
7. The relevant risk-free rate on 4-year obligations is 4%.

8. The historic variability of Needy Company's share price can be indicated by a standard deviation of annual returns of 25%.

In terms of IAS 32, the fair value of the conversion feature should be determined, if possible, and assigned to that embedded derivative. In this example, the popular Black-Scholes-Merton model will be used (but other approaches are also acceptable).

1. Compute the standard deviation of proportionate changes in the fair value of the asset underlying the option multiplied by the square root of the time to expiration of the option.

$$25 \times \sqrt{4} = .25 \times 2 = .50$$

2. Compute the ratio of the fair value of the asset underlying the option to the present value of the option exercise price.

- Since the expected dividend per share is €0.20 per year, the present value of this stream over 4 years would (at the risk-free rate) be €0.726.
- The shares are trading at €5.00.
- Therefore, the value of the underlying optioned asset, stripped of the stream of dividends that a holder of an unexercised option would obviously not receive, is

$$€ 5.00 - .726 = € 4.274 \text{ per share}$$

- The implicit exercise price is €1,000 ÷ 150 shares = €6.667 per share. This must be discounted at the risk-free rate, 4%, over 4 years, assuming that conversion takes place at the expiration of the conversion period, as follows:

$$€ 6.667 \div 1.04^4 = 6.667 \div 1.170 = € 5.699$$

- Therefore, the ratio of the underlying asset, €4.274, to the present value of the exercise price, €5.699, is .750.
3. Reference must now be made to a call option valuation table to assign a fair value to these two computed amounts (the standard deviation of proportionate changes in the fair value of the asset underlying the option multiplied by the square root of the time to expiration of the option, .50, and the ratio of the fair value of the asset underlying the option to the present value of the option exercise price, .750). For this example, assume that the table value is 13.44% (meaning that the fair value of the option is 13.44% of the fair value of the underlying asset).
4. The valuation of the conversion option, then, is given as

$$.1344 \times € 4.274 \text{ per share} \times 150 \text{ shares/bond} \times 500 \text{ bonds} = € 43,082$$

- Since the fair value of the options (€43,082) has been determined, this is assigned to the conversion option. The difference between the cost of the hybrid investment, €500,000, and the amount allocated to the conversion feature, €43,082, or €456,918, should be attributed to the debt instrument.
- The discount on the debt should be amortized, using the effective yield method, over the projected four-year holding period. The effective yield, taking into account the semi-annual interest payments to be received, will be about 7.54%.

If, for some reason, the value of the derivative (the conversion feature, in this case) could not be ascertained, the fair value of the debt portion would be computed, and the residual allocated to the derivative. This is illustrated as follows:

- Use the reference discount rate, 8%, to compute the market value of straight debt carrying a 5% yield.

PV of €500,000 due in four years, discounted at 8%	€365,345
PV of semi-annual payments of €12,500 for eight periods, discounted at 8%	84,159
Total	<u>€449,504</u>

2. Compute the residual amount allocable to the conversion feature.

Total proceeds from issuance of compound instrument	€500,000
Value allocable to debt	449,504
Residual value allocable to embedded derivative	<u>€50,496</u>

### ***Induced conversion of debt instruments***

A special situation may occur in that the conversion privileges of convertible debt are modified after issuance of the debt. These modifications may take the form of reduced conversion prices or additional consideration paid to the convertible debt holder. The debtor offers these modifications or “sweeteners” to induce prompt conversion of the outstanding debt. This is in addition to the normal strategy of calling the convertible debt to induce the holders to convert, assuming the underlying economic values make this attractive (debtors often do this when only a small fraction of the originally issued convertible debt remains outstanding). The issuance of these “sweeteners” should be accounted for as a reduction in the proceeds of the share offering, thereby reducing contributed capital from the transaction.

A previously acceptable alternative accounting treatment, recording the sweetener payments as an expense in the period of conversion, is no longer deemed appropriate given the proceeds allocation scheme mandated by revised IAS 32. That latter approach derived from a recognition that if it had been part of the original arrangement, a change in the exchange ratio or other adjustment would have affected the allocation of the original proceeds between debt and equity, and the discount or premium originally recognized would have been different in amount, and hence periodic amortization would have differed as well.

### ***Debt instruments issued with share warrants***

Warrants are certificates enabling the holder to purchase a stated number of shares at a certain price within a certain period. They are often issued with bonds to enhance the marketability of the bonds and to lower the bond’s interest rate.

Detachable warrants are similar to other features, such as the conversion feature discussed earlier, which under IAS 32 make the debt a compound financial instrument and which necessitates that there is an allocation of the original proceeds among the constituent elements. Since warrants, which will often be traded in the market, are easier to value than are conversion features, prior to the most recent revision to IAS 32 it was logical to employ pro rata allocation based on relative market values. However, since revised IAS 32 requires allocation of only residual value to the equity element of compound instruments consisting of both liability and equity components, that approach is no longer acceptable.

### ***Instruments having contingent settlement provisions***

Some financial instruments are issued which have contingent settlement provisions—that is, which may or may not require the issuer/obligor to utilize its resources in subsequent settlement. For example, a note can be issued that will be payable either in cash or in the issuer’s shares, depending on whether certain contingent events, such as the share price exceeding a defined target over a defined number of days immediately preceding the maturity

date of the note, are met or not. This situation differs from convertible debt, which is exchangeable into the shares of the borrower, at the holder's option.

Revised IAS 32 incorporates the conclusion previously set forth separately in SIC 5, *Classification of Financial Instruments—Contingent Settlement Provisions*, that a financial instrument is a financial liability when the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of *both* the issuer and the holder. Contingent settlement provisions are ignored when they apply only in the event of liquidation of the issuer or are not genuine.

Examples of such contingent conditions would be changes in a stock market index, the consumer price index, a reference interest rate or taxation requirements, or the issuer's future revenues, profit or loss or debt to equity ratio. The issuer cannot impact these factors and thus cannot unilaterally avoid settlement as a liability, delivering cash or other assets to resolve the obligation.

Under revised IAS 32, certain exceptions to the foregoing rule have been established. These exist when:

1. The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or
2. The issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

By "not genuine," IAS 32 means that there is no reasonable expectation that settlement in cash or other asset will be triggered. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of the entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

If the settlement option is only triggered upon liquidation, this possibility is ignored in classifying the instrument, since the going concern assumption, underlying IFRS-basis financial reporting, presumes ongoing existence rather than liquidation.

In other instances the instrument includes a "put" option (i.e., an option that gives the holder the right, but not the obligation, to cause the issuer to redeem it at a fixed or determinable price). Notwithstanding certain prominent features suggesting an equity ownership, under the provisions of the revised IAS 32, any such instruments would have to be classified as liabilities. Again, this is because the issuer does not retain an unconditional right to avoid settlement using cash or other resources of the entity.

It also happens that entities will enter into contractual obligations of a fixed amount or of an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments, but which the entity must or can settle by delivery of its own equity instruments, the number of which depends on the amount of the obligation. Under revised IAS 32, such an obligation must be reported as a financial liability of the entity, unless the terms are such that this is deemed "not genuine." The reasoning is that if the number of an entity's own shares or other own equity instruments required to settle an obligation varies with changes in their fair value so that the total fair value of the entity's own equity instruments to be delivered always equals the amount of the contractual

obligation, then the counterparty does not hold a true residual interest in the entity. Furthermore, settlement in shares could require the issuing entity to deliver more or fewer of its own equity instruments than would be the case at the date of entering into the contractual arrangement. This leads the IASB to conclude that such an obligation is a financial liability of the entity even though the entity must or can settle it by delivering shares.

### ***Treasury shares***

When an entity reacquires its own equity instruments (“treasury shares”), the consideration paid is deducted from equity. Treasury shares are not treated as assets, but are to be deducted from equity. No gain or loss should be recognized in profit or loss on the purchase, sale, issue or cancellation of an entity’s own equity instruments since transactions with shareholders do not affect profit or loss. Treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received from transactions with treasury shares should be recognized directly in equity. An entity must disclose the number of treasury shares held either in the statement of financial position or in the notes, in accordance with IAS 1. In addition, disclosures under IAS 24 must be provided if an entity reacquires its own shares from related parties.

### ***Reporting interest, dividends, losses and gains***

IAS 32 establishes that interest, dividends, losses and gains relating to a financial instrument or a component that is a financial *liability* should be recognized as income or expense in profit or loss. Distributions (dividends) paid on *equity* instruments issued should be charged directly to equity, and reported in the statement of changes in equity. Transaction costs of an equity transaction should be accounted for as a deduction from equity. An amendment that was made to IAS 32 as part of the Annual Improvements 2009–2011 Cycle (issued in May 2012) states that income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction is accounted for in accordance with IAS 12, *Income Taxes*, rather than net of tax as was previously the case. The statement of financial position classification of the instrument drives the statement of comprehensive income classification of the related interest or dividends. For example, if mandatorily redeemable preferred shares have been categorized as debt in the issuer’s statement of financial position, dividend payments on those shares must be recognized in profit or loss in the same manner as interest expense. Similarly, gains or losses associated with redemptions or refinancing of financial instruments classed as liabilities would be recognized in profit or loss, while gains or losses on equity are credited or charged to equity directly.

### ***Offsetting financial assets and liabilities***

Under the provisions of IAS 32, offsetting financial assets and liabilities is permitted only when the entity *both*:

- Has the legally enforceable right to set off the recognized amounts, and
- Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously. Simultaneous settlement of a financial asset and a financial liability can be presumed only under defined circumstances. The most typical of such cases is when both instruments will be settled through a clearinghouse functioning for an organized exchange. Other situations may superficially appear to warrant the same accounting treatment but in fact do not give rise to legitimate offsetting. For example,



if the entity will exchange cheques with a single counterparty for the settlement of both instruments, it becomes exposed to credit risk for a time, however brief, when it has paid the other party for the amount of the obligation owed to it but has yet to receive the counterparty's funds to settle the amount it is owed by the counterparty. Offsetting would not be warranted in such a context. In December 2011, the IASB issued an amendment to IAS 32 that clarified the application of offsetting of financial assets and liabilities. The amendment involved addressing the following items:

1. The meaning of "currently has a legally enforceable right of setoff"; and
2. What gross settlement systems may be considered equivalent to net settlement.

### ***Legally enforceable right of setoff***

This means that the right of setoff must not be contingent on a future event and it must be legally enforceable in all of the following circumstances:

1. The normal course of business;
2. The event of default; and
3. The event of insolvency or bankruptcy of the equity and all of the counterparties.

The nature and extent of the right of setoff, including any conditions attached to its exercise and whether it would remain in the event of default or insolvency or bankruptcy, may vary from jurisdiction to jurisdiction. As such, it cannot be assumed that the right of setoff is automatically available outside of the normal course of business. For example, the bankruptcy or insolvency laws of a jurisdiction may prohibit, or restrict, the right of setoff in the event of bankruptcy or insolvency in some circumstances and this needs to be taken into consideration in assessing whether or not the criteria set out above are met.

The standard sets forth a number of other circumstances in which offsetting would *not* be justified. These include:

1. When several different instruments are used to synthesize the features of another type of instrument (which typically would involve a number of different counterparties, thus violating a basic principle of offsetting).
2. When financial assets and financial liabilities arise from instruments having the same primary risk exposure (such as when both are forward contracts) but with different counterparties.
3. When financial assets are pledged as collateral for non-recourse financial liabilities (as the intention is not typically to effect offsetting, but rather, to settle the obligation and gain release of the collateral).
4. When financial assets are set aside in a trust for the purpose of discharging a financial obligation but the assets have not been formally accepted by the creditor (as when a sinking fund is established, or when in-substance defeasance of debt is arranged).
5. When obligations incurred as a consequence of events giving rise to losses are expected to be recovered from a third party by virtue of an insurance claim (again, different counterparties means that the entity is exposed to credit risk, however slight).

Even the existence of a master netting agreement does not automatically justify the offsetting of financial assets and financial liabilities. Only if both the stipulated conditions (both the right to offset and the intention to do so) are met can this accounting treatment be employed.

### *Disclosure requirements under IAS 32*

The disclosure requirements established by IAS 32 were later largely subsumed under those established by IAS 39. Per another revision in 2003, however, the disclosure requirements were again situated in IAS 32. In August 2005, all disclosure requirements were removed from IAS 32 (which continues as the authoritative source of presentation requirements) and placed in new IFRS 7. Disclosure requirements in accordance with IFRS 7 are discussed later in this chapter.

## **IAS 39: FINANCIAL INSTRUMENTS—RECOGNITION AND MEASUREMENT**

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### **Applicability**

IAS 39 is applicable to all financial instruments *except* those interests in subsidiaries, associates and joint arrangements that are accounted for in accordance with IFRS 10, IFRS 11 or IAS 28; rights and obligations under leases, to which IAS 17 applies (however, impairment and derecognition provisions for lease receivables, derecognition principles for finance lease payables and provisions of embedded derivatives for derivatives that are embedded in leases are part of the scope of IAS 39); rights and obligations under insurance contracts, to which IFRS 4 applies; employers' rights and obligations under employee benefit plans, to which IAS 19 applies; equity instruments issued by the reporting entity, to which IAS 32 applies; financial instruments, contracts and obligations under share-based payment transactions, to which IFRS 2 applies; forward contracts between an acquirer and a selling shareholder to buy or sell in an acquisition that shall result in a business combination, to which IFRS 3 applies; and the rights to payments to reimburse the reporting entity for expenditure it is required to make to settle a liability that it recognizes as a provision in accordance with IAS 37.

IAS 39 as originally promulgated was not applicable to financial guarantee contracts, such as letters of credit, when such contracts call for payments that would have to be made only if the primary debtor fails to perform; accounting for these types of arrangements was specified by IAS 37. However, amendments to IAS 39 and IFRS 4 made in 2005 have prescribed the accounting for guarantee contracts by the guarantor. It states that financial guarantees are initially to be measured at fair value, with subsequent measurement at the greater of the initial measurement and the best estimate as defined in IAS 37. The effect of this amendment was to bring the *recognition* decision under IAS 39, while leaving *measurement* guidance under IAS 37.

IAS 39 criteria apply where the guarantor will have to make payments when a defined change in credit rating, commodity prices, interest rates, security price, foreign exchange rate, an index of rates or prices, or other underlying indicator occurs. Also, if a guarantee arises from an event leading to the derecognition of a financial instrument, the guarantee must be recognized as set forth in this standard.

IAS 39 does not apply to contingent consideration arrangements pursuant to a business combination for business combinations concluded before the effective date of IFRS 3, *Business Combinations*.

The standard does not apply to contracts that require payments dependent upon climatic, geological or other physical factors or events, although if other types of derivatives are embedded therein, IAS 39 would set the requirements for recognition, measurement, disclosure and derecognition.

IAS 39 must be applied to commodity-based contracts that give either party the right to settle by cash or some other financial instrument, with the exception of commodity contracts that were entered into and continue to meet the entity's expected purchase, sale or usage requirements and were designated for that purpose at their inception. With regard to embedded derivatives, if their economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract, and if a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, they are to be separated from the host contract and accounted for as a derivative in accordance with the standard. IFRIC 9, *Reassessment of Embedded Derivatives*, provides additional interpretation concerning this matter. An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is *prohibited* unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract; in this case reassessment is required.

A first-time IFRS adopter should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of conditions existing at the later of the date it first becomes a party to the contract and the date a reassessment is required because a change in the terms of the arrangement significantly alters the cash flows otherwise mandated under the contract.

### **Initial Recognition and Measurement**

An entity should recognize a financial asset or a financial liability in its statement of financial position only when the entity becomes a party to the contractual provisions of that instrument. Debt and equity instruments held as financial assets (investments) are initially measured at fair value, including transactions costs directly attributable to the acquisition (e.g., fees, commissions, transfer taxes, etc.), as of the date when the reporting entity (investor entity) becomes a party to the contractual provisions of the instrument. In general this date is readily determinable and unambiguous. Transaction costs are *not* included in initial measurement of instruments classified as at fair value through profit or loss (FVTPL). Note that guidance on fair value measurement is now contained within IFRS 13, *Fair Value Measurement* and all references to fair value within IAS 39 should be read in the context of IFRS 13 which is covered in Chapter 25.

For instruments purchased "regular way" (when settlement date follows the trade date by several days), however, recognition may be on either the trade or the settlement date. In "regular-way purchase or sale" delivery must be within the time frame generally established by regulation or convention in the market concerned (e.g., settlement on T+3 days). An entity has a choice between the trade date or settlement date accounting rather than derivatives accounting, but a policy should be applied consistently for each category of financial assets. Any change in fair value between these dates must be recognized (strictly speaking, regular-way trades involve a forward contract, which is a derivative financial instrument, but IAS 39 does not require that these be actually accounted for as derivatives). If a transaction is considered "regular-way," a derivative is not recognized for the time period between the trade and the settlement date.

If an entity recognizes financial assets using the settlement date, any change in fair value of assets received between the trade date and the settlement date is recognized in profit or loss (if assets classified as at FVTPL) or equity (if assets classified as available-for-

sale); changes in fair value during this period are not recognized for assets carried at cost or amortized cost.

### Subsequent Measurement

**Subsequent measurement of financial assets.** The accounting of financial instruments is dependent upon whether instruments are classified as:

- At fair value through profit or loss (those held for trading and those designated as at fair value through profit or loss upon initial recognition);
- Available-for-sale;
- Held-to-maturity; or
- Loans and receivables.

All financial assets shall be measured at their fair value (without any deduction for transaction costs they may incur on sale or disposal) except for:

- Loans and receivables—measured at amortized cost using the effective interest rate method;
- Held-to-maturity—measured at amortized cost using the effective interest rate method;
- Equity investments that do not have a quoted price in an active market or whose fair value cannot be reliably measured (using other techniques)—measured at cost.

All financial assets except those measured at fair value through profit or loss are subject to an impairment review at each reporting date.

**Subsequent measurement of financial liabilities. All financial liabilities are to be measured at amortized cost except for:**

- Financial liabilities at fair value through profit or loss—measured at fair value. A derivative liability that is linked to and must be settled by delivery of an equity instrument that does not have a quoted price in an active market and whose fair value cannot be reliably measured is measured at cost;
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition;
- Financial guarantee contracts, whereby the contract requires 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 in accordance with the original or modified terms of a debt instrument;
- Commitments to provide a loan at below market interest rates.

### Gains and Losses

Gains and losses arising from a change in fair value of a financial asset or financial liabilities are recognized as follows:

- Fair value through profit or loss—is recognized in profit or loss;
- Available-for-sale—recognized in other comprehensive income except for impairment losses, interest, dividends and foreign exchange differences, which are recognized in profit or loss;

- Held-to-maturity, loans and receivables, and financial liabilities measured at amortized cost—all gains and losses including impairment are recognized in profit or loss. For financial assets or financial liabilities that are hedged items different treatments are required (refer to Chapter 23);
- Debt instruments to be held to maturity are maintained at amortized cost, unless objective evidence of impairment exists. Of course, this assumes that the conditions for classification as held-to-maturity as set forth by IAS 39 are met; namely, that management has demonstrated both the intent and the ability to hold the instruments until the maturity date.

Given the explicit presumption that financial instruments carried at fair value through profit or loss will be disposed of in the near term, as market conditions may warrant, marking these to fair value through profit and loss is entirely logical, and mandatory.

Under provisions of the original IAS 39, the changes in fair value for available-for-sale financial assets could either be included in profit or loss, or recognized in other comprehensive income, although each reporting entity had been required to make a onetime election as to which of these alternatives it would conform to thereafter. However, subsequent revisions to IAS 39 have eliminated this option, so optional recognition in profit or loss is not permitted, although the “fair value (FVTPL) option” is available and accomplishes the same objective (see discussion below).

When an investment in bonds is classified as available-for-sale, so that fair value changes are reported in other comprehensive income and accumulated in equity until the investment is sold, the amortization of premium or discount on such an investment should nonetheless be reported in profit or loss as part of interest income or expense. Amortization cannot be included as part of the change in fair value and included in other comprehensive income. Under provisions of IAS 39, as well as under provisions of IAS 18 and IAS 32, these amounts are measured using the effective interest method, which means that the amortization of premium or discount is part of interest income or interest expense and therefore included in determining net profit or loss.

The transaction costs included in the originally recorded basis of held-to-maturity financial assets are included in the calculation of effective interest rate and amortized to profit or loss over the expected life of the investment, as part of any premium or discount. Transaction costs included in the carrying value of financial assets classified as available-for-sale are recognized as part of changes in fair value. If available-for-sale instruments have fixed or determinable payments, transaction costs are amortized to the P&L using the effective interest method. For those instruments listed as available-for-sale without fixed or determinable payments, costs are recognized in the P&L when the assets are derecognized or impaired.

## **Derecognition**

### ***Derecognition of financial assets***

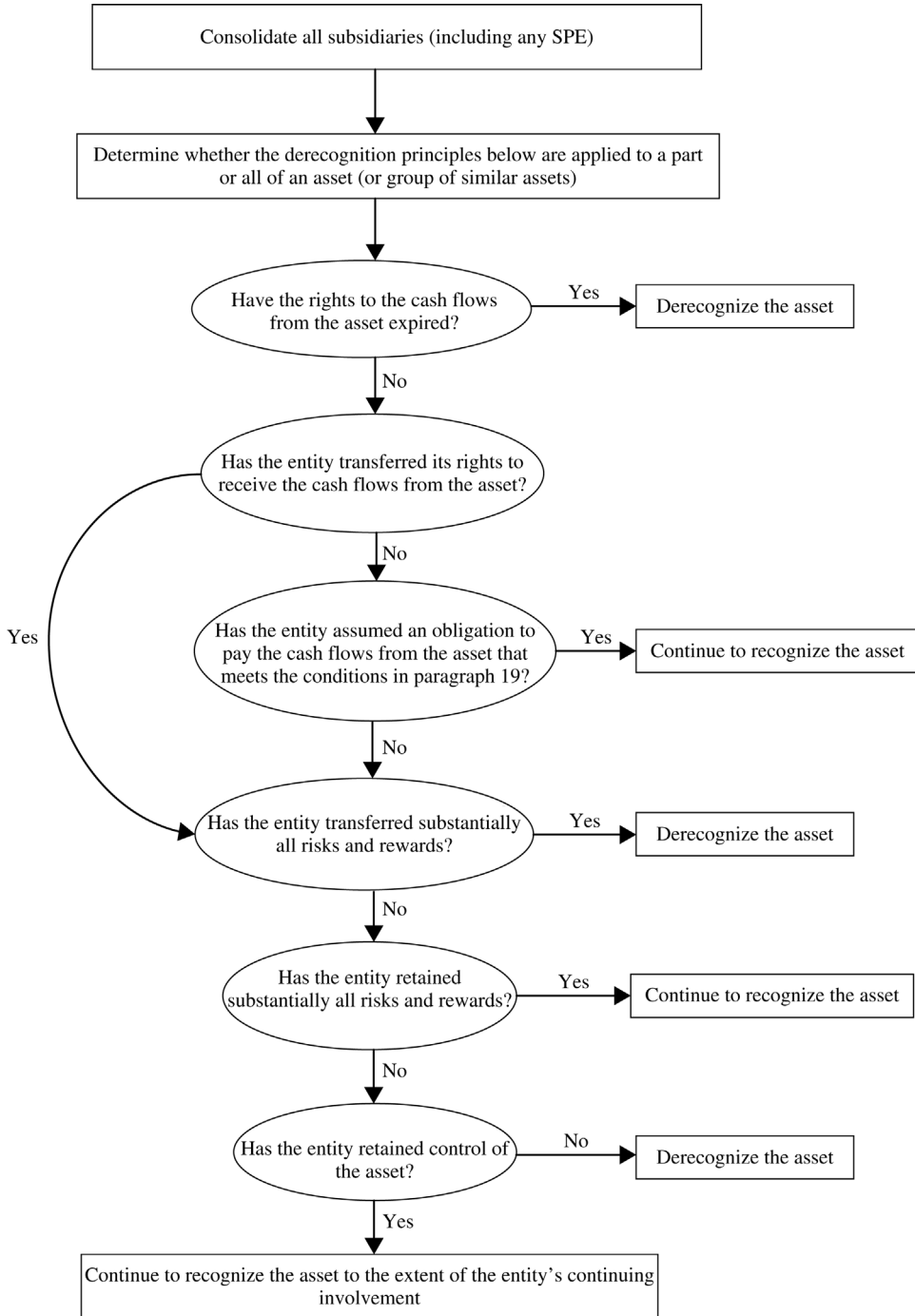
IAS 39 prescribes the accounting treatment for derecognition of a financial asset. A guiding principle has become the “continuing involvement approach,” which prohibits derecognition to the extent to which the transferor has continuing involvement in an asset or a portion of an asset it has transferred.

In accordance with IAS 39 there are two main concepts—risks and rewards, and control—that govern derecognition decisions. The standard makes it clear that evaluation

**Table 1. Subsequent Measurement of Financial Assets: Summary**

Category	Measurement	Changes in carrying amount	Valuation basis	Impairment	Reversibility of impairment
Financial assets at fair value through profit and loss	Fair value	Profit or loss	Active market price or technique	Profit or loss	Yes, in profit or loss, restricted to the amortized cost at date of impairment
Available-for-sale	Fair value (certain exemptions as above)	Other comprehensive income. Interest, dividend, foreign exchange differences are recognized in profit or loss	Active market price or technique	Profit or loss	Equity instruments via other comprehensive income. All others through profit or loss to the extent recognized in profit or loss
Loans and receivables	Amortized cost	Interest and foreign exchange differences are recognized in profit or loss	Adjusted cost	Profit or loss	Yes, in profit or loss, restricted to the amortized cost at date of impairment. No reversal allowed for financial assets which are carried at cost due to the unavailability of fair value
Held-to-maturity	Amortized cost	Interest and foreign exchange differences are recognized in profit or loss	Adjusted cost	Profit or loss	Yes, in profit or loss, restricted to the amortized cost at date of impairment
Financial liabilities measured at amortized cost	Amortized cost	Interest and foreign exchange differences are recognized in profit or loss unless requirements of IAS 23 apply	Adjusted cost	Not applicable	Not applicable
Financial liabilities measured at fair value through profit or loss	Fair value	Profit or loss	Active market price or technique	Not applicable	Not applicable

of the transfer of risks and rewards of ownership must in all instances precede the evaluation of the transfer of control.



The derecognition approach should be considered at the consolidated group level after applying IFRS 10 prior to derecognition assessment. In accordance with IFRS 10 all controlled entities should be included in the consolidated financial statements. IFRS 10 requires that a special-purpose entity (SPE) be consolidated if the substance of the relationship indicates that the SPE is controlled by the reporting entity. The term “financial asset” refers to either a part of a financial asset or a part of a group of similar assets.

An entity needs to determine whether derecognition principles are applied to a part or all of a financial asset (or group of similar assets). Derecognition is applied to a part of an asset transferred only if the part comprises:

- Specifically identified cash flows (e.g., an interest-only strip) when the counterparty obtains the right to interest cash flows but not the principal cash flows from a debt instrument;
- A fully proportionate (pro rata) share of cash flows (e.g., 90% of all cash flows); and;
- A fully proportionate share of specifically identified cash flows (e.g., 90% of interest cash flows from a financial asset).

Unless one of the foregoing criteria is satisfied, derecognition of a portion of a financial asset is not permitted. In that case, the financial asset must be considered for derecognition in its entirety.

An entity should derecognize a previously recognized financial asset from its statement of financial position *only* when:

- The contractual rights to the cash flows from the financial asset expire (e.g., expired option); or
- It transfers the financial asset and the transfer qualifies for derecognition (as explained in the paragraph above).

An entity transfers a financial asset if and only if:

1. It transfers the contractual rights to receive the cash flows of the financial asset; or
2. It retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in a “pass-through arrangement.”

If the entity has transferred its rights to receive the cash from the financial asset, the next step would be to consider whether risks and rewards of ownership are transferred. If rights to the cash flows are retained, an entity should consider whether a “pass-through arrangement” exists. The entity treats the transaction as a transfer of a financial asset when all of the following three conditions are met for the transaction to be a “pass-through arrangement”:

1. The entity has no obligation to pay amounts not collected, to the eventual recipients. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
2. The entity is prohibited (by terms of the transfer) from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
3. The entity has an obligation to remit any cash flows collected on behalf of the eventual recipients without material delay (a material delay can be defined as a



significant delay in passing on the cash flows of a transferred asset that alters the credit risk characteristics for the eventual recipient when compared to the original transferred asset). In addition, the entity must not be entitled to reinvest the cash flows, except for investments in cash or cash equivalents; and interest earned (if any) on such investments must be passed on to the eventual recipients.

When an entity transfers a financial asset, the next step in applying derecognition principles is to evaluate the extent to which it retains the risks and rewards of ownership of the financial asset.

If the entity has transferred substantially all the risks and rewards of ownership of the financial asset, the entity should derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer. The entity's exposure before and after the transfer should be evaluated; risks and rewards are retained if exposure to variability in cash flows does not change significantly as a result of the transfer. Examples of transactions when the entity transfers substantially all of the risks and rewards of ownership include:

- Unconditional sale of a financial asset; and
- Sale of a financial asset with an option to repurchase at fair value at the time of repurchase.

If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity should not remove this asset from its statement of financial position and continue to recognize the financial asset. Examples of transactions when substantially all risks and rewards are retained include:

- Sale and repurchase transaction with repurchase price being fixed;
- Sale of a financial asset with a total return swap;
- Sale of a financial asset with a deep-in-the-money option (and it is highly unlikely to go out of the money before expiry); and
- Sale of short-term receivables with a guarantee to compensate for likely-to-occur credit losses.

If the entity *neither* transfers *nor* retains substantially all the risks and rewards of ownership of the financial asset, the next step is to determine whether it has retained *control* of the financial asset.

- If control has not been retained, the entity derecognizes the financial asset and recognizes separately as assets or liabilities any rights and obligations created or retained in the transfer.
- If the entity has retained control, it continues to recognize the financial asset to the extent of its continuing involvement in the financial asset.

In accordance with IAS 39, whether the entity has retained control of the transferred asset depends on the transferee's ability to sell the assets to an unrelated third party; to exercise that ability unilaterally; and without needing to impose additional restrictions on the transfer. In all other cases, the entity has retained control and continues recognizing the financial asset to the extent of continuing involvement and recognizing an associated liability. Examples of continuing involvements and the requisite measurement approaches include:

1. Repurchase agreements and securities lending. If a financial asset is sold under an agreement to repurchase it at a fixed price/at the sale price plus a lender's return/if it is loaned at under an agreement to return it to the transferor, it is not derecognized because the transferor retains substantially all the risk and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its financial statements, e.g., loaned asset of repurchase receivable.
2. Repurchase agreements and securities lending. Assets that are substantially the same. If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return, or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
3. Repurchase agreements and securities lending. Rights of substitution. If a repurchase agreement at a fixed purchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
4. Repurchase right of first refusal at fair value. If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognizes the asset because it has transferred substantially all the risks and rewards of ownership.
5. Wash sale transaction. The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognized.
6. Put options and call options that are deeply in the money. If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
7. Put options and call options that are deeply out of the money. A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognized. This is because the transferor has transferred substantially all the risks and rewards of ownership.
8. Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money. If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognized. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in

the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

9. A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognized to the extent of the transferor's continuing involvement. The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognized.
10. Assets subject to a fair value put or call option or a forward repurchase agreement. A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
11. Cash-settled call or put options. An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control.
12. Removal of accounts provision. A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets).
13. Clean-up calls. An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
14. Subordinated retained interests and credit guarantees. An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the entity retains some, but not substantially all, of the risks and

- rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
15. Total return swaps. An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
  16. Interest rate swaps. An entity may transfer to a transferee a fixed-rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
  17. Amortizing interest rate swaps. An entity may transfer to a transferee a fixed-rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortizes so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognize all of the transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. Conversely, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

If an entity has retained control of a financial instrument, measurement of the financial asset and financial liability is on the basis that reflects rights and obligations that the entity has retained. The entity continues to recognize an asset to the extent of its continuing involvement, and also recognizes the associated liability, measured so that net carrying amount of the transferred asset and associated liability is:

- Amortized cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortized cost; or
- Equal to the fair value of the rights and obligations retained by the entity, if the transferred asset is measured at fair value.

### ***Derecognition of financial liabilities***

According to IAS 39, removing a financial liability (or part of a financial liability) from the reporting entity's statement of financial position is warranted only when the obligation is *extinguished*. This will be deemed to have occurred when the obligation specified in the contract is discharged or cancelled or expires.

In some instances, the debt issuer exchanges newly issued debt carrying different terms (as to maturities, interest rates, etc.) for outstanding debt. Under IAS 39, under such

circumstances the original debt will be deemed extinguished, and a new liability will be deemed to have been incurred. Likewise, substantial modifications to the terms of existing financial liabilities, or to a part of that debt, whether this is attributable to financial exigencies or not, are accounted for as extinguishments.

If there is a difference between the carrying amount (i.e., book value) of a financial liability extinguished or transferred (or relevant portion thereof) and the consideration paid to accomplish this, including the fair value of non-cash assets transferred or liabilities assumed, this gain or loss will be recognized in profit or loss.

When only a part of an existing liability is repurchased, the carrying value is allocated pro rata between the part extinguished and the part that remains outstanding. This allocation is to be based upon relative fair values. Gain or loss is recognized as the difference between the carrying value allocated to the portion extinguished and the consideration paid to accomplish this extinguishment, using the same approach as described above.

If the extinguishment of debt does not occur on the interest date, the interest payable accruing between the last interest date and the acquisition date must also be recorded.

#### Example of accounting for the extinguishment of debt

1. A 10%, 10-year, €200,000 bond is dated and issued on 1/1/20XX at €98, with the interest payable semi-annually.
2. Associated bond issue costs of €14,000 are incurred.
3. Four years later, on 1/1/20XX+4 the entire bond issue is repurchased at €102 per €100 face value and is retired.
4. The straight-line method of amortization is used since the result is not materially different from that when the effective interest method is used.

The gain or loss on the repurchase is computed as follows:

Reacquisition price [(102/100) × €200,000]	€204,000	
Net carrying amount:		
Face value	€200,000	
Unamortized discount [2% × €200,000 × (6/10)]	(2,400)	
Unamortized issue costs [€14,000 × (6/10)]	(8,400)	<u>189,200</u>
Loss on bond repurchase		€ <u><u>14,800</u></u>

#### *Gain or loss on derecognition of financial liabilities*

The difference between the net carrying value and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recorded as a gain or loss. If the acquisition price is greater than the carrying value, a loss is incurred and must be accounted for. A gain is generated if the acquisition price is less than the carrying value. These gains or losses are to be recognized in the period in which the extinguishment takes place. These should be reported as “other” income or expense, because this is the same profit or loss category where interest expense is normally reported. It would not be appropriate, however, to include any gain or loss in the interest pool from which capitalized interest is computed under IAS 23 (discussed in Chapter 10).

#### *Substantial modification of the terms of existing debt instruments*

When an existing borrower and lender of debt exchange instruments with substantially different terms, this represents an extinguishment of the old debt and results in

derecognition of that debt and recognition of a new debt instrument. IAS 39 defines “substantial modification of the terms” of an existing debt instrument and the standard requires that those modifications should be accounted for as extinguishments, provided that the discounted present value of cash flows under the terms of the new debt differs by at least 10% from the discounted present value of the remaining cash flows of the original debt instrument.

In computing the discounted present values for determining whether the 10% limit has been exceeded, the effective interest rate of the (old) debt being modified or exchanged is to be used. If the difference in present values is at least 10% the transaction is to be accounted for as an extinguishment of the old debt. In such case, the new, modified debt is initially recognized at fair value. On the other hand, a difference of less than 10% is to be amortized over the remaining term of the debt instrument. In this instance, the debt is not to be remeasured at fair value and any costs or fees incurred adjust the carrying value of the debt and will be amortized by the effective interest method.

If an exchange of debt instruments, or if a modification of terms is accounted for under IAS 39 as an extinguishment, costs or fees incurred are to be recognized as part of the gain or loss incurred in the extinguishment. In non-extinguishment instances, any costs or fees incurred in the transaction are to be accounted for as adjustments to the carrying amount of the liability, to be amortized over the remaining term of the modified loan.

Under IAS 39, the reasons for the debt modification or exchange are irrelevant to the determination of the accounting to be applied. In this regard, IFRS contrasts with US GAAP, which historically had applied different accounting to those debt modifications which were identified as “troubled debt restructurings.”

#### Example of accounting for debt exchange or restructuring with gain recognition

Assume that Debtor Corp. owes Friendly Bank €90,000 on a 5% interest-bearing non-amortizing note payable in five years, plus accrued and unpaid interest, due immediately, of €4,500. Friendly Bank agrees to a restructuring to assist Debtor Corp., which is suffering losses and is threatening to declare bankruptcy. The interest rate is reduced to 4%, the principal is reduced to €72,500, and the accrued interest is forgiven outright. Future payments will be on normal terms.

Whether there is recognition of a gain on the restructuring depends on the 10% threshold. The relevant discount rate to be used to compare the present values of the old and the new debt obligations is 5%. The present value of the old debt is simply the principal amount, €90,000, plus the interest due at present, €4,500, for a total of €94,500.

The present value of the replacement debt is the discounted present value of the reduced principal and the reduced future interest payments; the forgiven interest does not affect this. The new principal, €72,500, discounted at 5%, equals €56,806. The stream of future interest payments ( $€72,500 \times .04 = €2,900$  annually in arrears), discounted at 5%, equals €12,555. The total present value, therefore, is €69,361, which is about 27% below the present value of the old debt obligation. Thus, the 10% threshold is exceeded, and a gain will be recognized at the date of the restructuring.

However, given Debtor’s current condition, the market rate of interest for its debt would actually be 12%, and since the new obligation must be recorded at fair value, this must be computed. The present value of the reduced principal, €72,500, discounted at 12%, has a present value of €41,138. The stream of future interest payments ( $€72,500 \times .04 = €2,900$  annually, in arrears), discounted at 12%, has a present value of €10,454. The total obligation thus has a fair value of €51,592.

The entry to record this event would be:

Debt obligation (old) payable	90,000	
Interest payable	4,500	
Discount on debt obligation (new)	20,908	
Debt obligation (new) payable		72,500
Gain on debt restructuring		42,908

Note that the new debt obligation is recorded at a net of €51,592, not at the face value of €72,500. The difference, €20,908, is a discount to be amortized to interest expense over the next five years, in order to reflect the actual market rate of 12%, rather than the nominal 4% being charged. Amortization should be accomplished on the effective yield method.

#### Example of accounting for debt exchange or restructuring with gain deferral

Assume now that Hopeless Corp. owes Callous Bank €90,000 on a 5% interest-bearing non-amortizing note payable in five years, plus accrued and unpaid interest, due immediately, of €4,500. Callous Bank agrees to a restructuring to assist Hopeless Corp., which is also suffering losses and is threatening to declare bankruptcy. However, Callous is only willing to reduce the principal amount from €90,000 to €85,000, and reduce interest to 4.5% from 5%. It is not willing to forego the currently owed €4,500 interest payment, and furthermore requires that the loan maturity be shortened to three years, from five, in order to limit its risk. Hopeless agrees to the new terms.

In order to comply with IAS 39, the present value of the new debt must be compared to the present value of the old, existing obligation. As in the preceding example, the present value of the old debt is simply the principal amount, €90,000, plus the interest due at present, €4,500, for a total of €94,500.

The present value of the replacement debt is the discounted present value of the reduced principal and the reduced future interest payments, plus the interest using a 5% discount factor (= .86384 for the new three-year term). The discounted present value of the reduced principal is €73,426. The stream of future interest payments ( $€85,000 \times .045 = €3,825$  annually in arrears), discounted at 5% (= 2.7231 annuity factor), has a present value of €10,416. The total present value, therefore, is ( $€73,426 + €10,416 + €4,500 =$ ) €88,342, which is about 7% below the present value of the old debt obligation. Accordingly, since the 10% threshold is not exceeded, the difference of ( $€94,500 - €88,342 =$ ) €6,158 is not recognized as a gain at the date of the restructuring, but rather is deferred and amortized over the new three-year term of the restructured loan.

The entry to record this event would be:

Debt obligation (old) payable	90,000	
Discount on debt obligation (new)	1,158	
Debt obligation (new) payable		85,000
Deferred gain on debt restructuring		6,158

Note that the new debt obligation is recorded at a net of €83,842, not at the face value of €85,000. The difference of €1,158 represents a discount to be amortized to interest expense over the subsequent three years; this will result in an interest expense at the actual market rate of 5%, rather than at the nominal 4.5% rate. Amortization should be computed on the effective yield method, although if the discrepancy is not material the straight-line method may be employed. The deferred gain, €6,158, will be amortized over the three-year revised term. While the discount amortization will be added to interest expense. IAS 39 is silent as to how the amortization of the deferred gain should be handled. However, by reference to how a gain in excess of the 10% threshold (and thus been subject to immediate recognition) would have been reported, it is thought likely that this amortization should be included in “other income,” and should not be offset against interest expense.

Presentation of the gain or loss from debt restructurings is not explicitly dealt with under IFRS. However, since IAS 8 was revised, as part of the IASB's *Improvements Project* to eliminate the presentation of extraordinary items in profit or loss, there is no difficulty in making the appropriate decision. Gain or loss on debt extinguishments should, in the authors' opinion, be displayed as items of "other" income or expense in profit or loss.

### ***Determining fair value***

In accordance with IAS 39, fair value is the price that would be received to sell an asset, or pay to transfer a liability in an orderly transaction between market participants at the measurement date. Chapter 25 discusses in further detail IFRS 13, *Fair Value Measurement*.

**Fair value through profit or loss (FVTPL) option.** A financial asset or financial liability would be classified as FVTPL when it meets either of the following conditions:

- It is classified as held for trading and:
  - It is acquired or incurred principally for the purpose of selling or repurchasing in the near term;
  - On initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit making; or
  - It is a derivative except for a financial guarantee contract or a designated and effective hedging instrument.
- Upon initial recognition an entity can designate any financial asset or financial liability as one to be measured at fair value, with changes in fair value recognized in current profit or loss. However, this election can only be made upon initial recognition. To preclude the obvious temptation to selectively determine which assets to treat this way from one period to the next, the reporting entity is prohibited from reclassifying financial instruments into or out of this category. Thus, the election is irrevocable upon initial recognition. Since it will not be known at the date of initial recognition whether the fair value of the instrument will increase or decrease in subsequent periods, manipulation of financial results cannot easily occur.

The fair value option can be employed in connection with either available-for-sale or held-to-maturity investments. Designation is made on an instrument-by-instrument basis and the whole instrument approach, so a portion (e.g., 80%) of a financial instrument or a component (e.g., interest rate risk only) cannot be designated. Investments in equity instruments that do not have quoted prices in active markets and whose fair value cannot be reliably measured are *not* eligible for designation as FVTPL.

### ***Constraints on use of held-to-maturity classification***

Under IAS 39, held-to-maturity investments are non-derivative financial assets having fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than those that:

1. The entity designates as being carried at fair value through profit or loss at the time of initial recognition;
2. The entity designates as available-for-sale; or
3. Meet the definition of loans and receivables.



Importantly, an entity is not permitted to classify any financial assets as held-to-maturity if it has, during the current financial reporting year or during the two preceding financial reporting years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity other than sales or reclassifications that:

1. Are so close to maturity or to the asset's call date (e.g., less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value over that time interval;
2. Occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments (e.g., from payments on serial bonds) or prepayments; or
3. Are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

In applying the foregoing rule, *more than insignificant* is evaluated in relation to the total amount of held-to-maturity investments.

It is clear that an entity cannot have a demonstrated ability to hold an investment to maturity if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. One question that arises is whether a debt security that has been pledged as collateral or transferred to another party under a repurchase agreement ("repo") or instruments lending transaction and continues to be recognized by the reporting entity, can still be classified as a held-to-maturity investment. According to the IGC (IASB's Implementation Guidance Committee), an entity's intent and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or instruments lending agreement. However, an entity does not have the positive intent and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments. Thus, the specific facts and circumstances of the repo arrangement must be given careful consideration in concluding on the classification of the instruments.

The rules against early sales of instruments that had been classified as held-to-maturity are quite severe. For example, if an investor sells a significant amount of financial assets classified as held-to-maturity, and does not thereafter classify any financial assets acquired subsequently as held-to-maturity, but maintains that it still intends to hold the remaining investments originally categorized as held-to-maturity to their respective maturities and accordingly does not reclassify them, the reporting entity will be deemed to be not in compliance with IAS 39. Thus, whenever a sale or transfer of more than an insignificant amount of financial assets classified as held-to-maturity results in the conditions in IAS 39 not being satisfied, no instruments should continue to be classified in that category. Any remaining held-to-maturity assets must be reclassified as available-for-sale. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification as prescribed by the standard. Once this violation has occurred, at least two full years must pass before an entity can again classify financial assets as held-to-maturity.

Another question concerning continuing classification of investments as held-to-maturity relates to sales that are triggered by a change in the management of the investor entity. According to the IGC, such sales would definitely compromise the classification of other financial assets as held-to-maturity. A change in management is not identified under IAS 39 as an instance where sales or transfers from held-to-maturity do not compromise the

classification as held-to-maturity. Sales that are made in response to such a change in management would, therefore, call into question the entity's intent to hold any of its investments to maturity.

The IGC cited an example similar to the following: A company held a portfolio of financial assets that was classified as held-to-maturity. In the current period, at the direction of the board of directors, the entire senior management team was replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the board, as part of its recovery strategy. Although the previous management team had been in place since the entity's inception and the company had never before undergone a major restructuring, the sale will nevertheless call into question this entity's intent to hold remaining held-to-maturity financial assets to maturity. If the sale goes forward, all held-to-maturity instruments would have to be reclassified, and the entity will be precluded from using that classification for investments for another two years (the "tainting" rule).

Another indication of the stringency of the requirements for classifying instruments as held-to-maturity is suggested by an IGC position on sales made to satisfy regulatory authorities. In some countries, regulators of banks or other industries may set capital requirements on an entity-specific basis based on an assessment of the risk in that particular entity. IAS 39 indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator of the industry's capital requirements may do so under that standard without necessarily raising a question about its intention to hold other investments to maturity. The IGC has ruled, however, that sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators will indeed "taint" the entity's intent to hold other financial assets as held-to-maturity. Thus, unless it can be demonstrated that the sales fulfill the condition in IAS 39 in that the sales were the result of an increase in capital requirements which was an isolated event that was beyond the entity's control and that is non-recurring and could not have been reasonably anticipated by the entity.

### ***Held-to-maturity investments disposed of before maturity***

As noted above, an entity may not classify any financial asset as held-to-maturity unless it has both the positive intent and ability to hold it to maturity. To put teeth into this threshold criterion, IAS 39 stipulates that, if a sale of a held-to-maturity financial asset occurs, it calls into question the entity's intent to hold all other held-to-maturity financial assets to maturity. However, IAS 39 provides exceptions for held-to-maturity investments that can be disposed of before maturity under certain conditions: for sales "close enough to maturity," and after collection of "substantially all" of the original principal.

Questions have arisen in practice on how these conditions should be interpreted. The IGC has offered certain insights into the application of these exception criteria. As interpreted, these conditions relate to situations in which an entity can be expected to be indifferent whether to hold or sell a financial asset because movements in interest rates—occurring after substantially all of the original principal has been collected or when the instrument is close to maturity—will not have a significant impact on its fair value. In such situations, a sale would not affect reported net profit or loss and no price volatility would be expected during the remaining period to maturity.

More specifically, the condition "close enough to maturity" addresses the extent to which interest rate risk is substantially eliminated as a pricing factor. According to the IGC,

if an entity sells a financial asset less than three months before its scheduled maturity, the application of the held-to-maturity classification can still be used. The impact on the fair value of the instrument for a difference between the stated interest rate and the market rate generally would be small for an instrument that matures in three months, in contrast to an instrument that matures in several years, for example.

The condition of having collected “substantially all” of the original principal provides guidance as to when a sale is for not more than an insignificant amount. Thus, if an entity sells a financial asset after it has collected 90% or more of the financial asset’s original principal through scheduled payments or prepayments, the requirements of IAS 39 would probably not be deemed to have been violated. However, if the entity has collected only 10% of the original principal, then that condition clearly is not met. The 90% threshold is apparently not meant to be absolute, so some judgement is still needed to operationalize this exception.

In some cases a debt instrument will have a put option associated with it; this gives the holder (the investor) the right, but not the obligation, to require that the issuer redeem the debt, under defined conditions. The existence of the put option need not be an impediment to held-to-maturity classification. IAS 39 permits an entity to classify a puttable debt instrument as held-to-maturity, provided that the investor has the positive intent and ability to hold the investment until maturity and does not intend to exercise the put option. However, if an entity has sold, transferred, or exercised a put option on more than an insignificant amount of other held-to-maturity investments, the continued use of the held-to-maturity classification would be prohibited, subject to exceptions for certain sales (very close to maturity, after substantially all principal has been recovered, and due to certain isolated events). The IGC has stated that these same exceptions apply to transfers and exercises (rather than outright sales) of put options in similar circumstances. The IGC cautions, however, that classification of puttable debt as held-to-maturity requires great care, as it seems inconsistent with the likely intent when purchasing a puttable debt instrument. Given that the investor presumably would have paid extra for the put option, it would seem counterintuitive that the investor would be willing to represent that it does not intend to exercise that option.

In addition to debt instruments being held to maturity, any financial asset that does not have a quoted market price in an active market, fair value of which cannot be reliably measured, will of necessity also be maintained at cost, unless there is evidence of impairment in value. Furthermore, loans or receivables which are originated by the reporting entity, and which are *not* held for trading purposes, are also to be maintained at cost, per IAS 39. Loans or receivables that are acquired from others, however, are accounted for in the same manner as other debt instruments (i.e., they must be classified as at fair value through profit or loss, available-for-sale, or held-to-maturity, and accounted for accordingly).

Under IAS 39, held-to-maturity financial assets (i.e., debt instruments held for long-term investment) and loans and receivables are measured at amortized cost, using the effective interest method. This requires that any premium or discount be amortized not on the straight-line basis, but rather by the effective interest method, in order to achieve a constant yield on the amortized carrying value. One question that arises is how discount or premium arising in connection with the purchase of a variable-rate debt instrument should be amortized (i.e., whether it should be amortized to maturity or to the next repricing date).

The IGC has ruled that this depends generally on whether, at the next repricing date, the fair value of the financial asset will be its par value. In theory, of course, a constantly repricing variable-rate instrument will sell at or very close to par value, since it offers a

current yield fully reflective of market rates and the issuer's credit risk. Accordingly, the IGC notes that there are two potential reasons for the discount or premium: it either (1) could reflect the timing of interest payments—for instance, because interest payments are in arrears or have otherwise accrued since the most recent interest payment date or market rates of interest have changed since the debt instrument was most recently repriced to par—or (2) the market's required yield differs from the stated variable rate, for instance, because the credit spread required by the market for the specific instrument is higher or lower than the credit spread that is implicit in the variable rate.

Thus, a discount or premium that reflects interest that has accrued on the instrument since interest was last paid or changes in market rates of interest since the debt instrument was most recently repriced to par is to be amortized to the date that the accrued interest will be paid and the variable interest rate will be reset to the market rate. On the other hand, to the extent the discount or premium results from a change in the credit spread over the variable rate specified in the instrument, it is to be amortized over the remaining term to maturity of the instrument. In this case, the date the interest rate is next reset is not a market-based repricing date of the entire instrument, since the variable rate is not adjusted for changes in the credit spread for the specific issue.

## **Reclassifications**

### ***2008 relaxation of rules against reclassifications from the held-for-trading category***

There was originally only a limited ability to revise the classification of investments in financial instruments under IAS 39. This limitation was imposed to preclude manipulation of profit or loss by, for example, deciding on a period-by-period basis which value changes will be reflected in profit or loss and which will be reported in other comprehensive income (and thus accumulated directly in equity). Entities cannot reclassify instruments that were designated as at fair value through profit or loss using the fair value option, nor derivatives.

In October 2008, the IASB published amendments to IAS 39 and IFRS 7 to allow reclassification of certain financial instruments from held-for-trading to held-to-maturity, loans and receivables, or available-for-sale categories under certain circumstances. The amendments were made in response to requests by regulators to allow banks to measure instruments that are no longer traded in an active market at amortized cost, and consequently reducing reported profit or loss volatility. Under US GAAP, transfers from those categories are restricted but still possible, whereas under IAS 39 no such reclassifications were previously permitted. This change to IFRS thus moves practice somewhat closer to that under US GAAP, at least in this limited domain.

Entities are allowed to reclassify certain financial instruments out of the held-for-trading category if the original intent has changed and they are no longer held for sale in the near future. The amended IAS 39 distinguishes between those financial assets that are eligible for classification as loans and receivables and those that are not. Financial assets are eligible for classification as loans and receivables if they are held for trading and, in addition, have fixed or determinable payments, are not quoted in an active market, and are those for which the holder should recover substantially all of its initial investment, other than as might be impacted by credit deterioration.

Financial assets that are not eligible for classification as loans and receivables can be transferred from the held-for-trading category to held-to-maturity or to available-for-sale only in "rare" circumstances. The Basis for Conclusions to IAS 39 states that "rare" circumstances arise from a single event that is "unusual and highly unlikely to recur in

the near term.” On its website, the IASB has confirmed that the deterioration of world markets that occurred during the third quarter of 2008 is a possible example of rare circumstances. It is thus clear that the unusual occurrences of mid-to-late 2008, which continued through at least the first part of 2009, provided the impetus for this significant change to IFRS, which was (and will continue to be) rather controversial.

In addition, concerning loans and receivables, if an entity has the intention and the ability to hold the asset for the “foreseeable future” or until maturity, then:

- Financial assets that would *now* meet the criteria to be classified as loans and receivables may be transferred from held-for-trading to loans and receivables; and
- Financial assets that would now meet the criteria to be classified as loans and receivables may be reclassified out of the available-for-sale category to loans and receivables.

The reclassification should be based on the fair value on the date of reclassification, which becomes the new cost (or amortized cost) basis. For example, an instrument that was acquired at its par value of €1,000, had declined in fair value to €700, and is now reclassified as held-to-maturity, should be measured at amortized cost of €700. Any difference between the new amortized cost and the instrument’s expected recoverable amount is amortized using the new effective interest rate over the expected remaining life, similar to the amortization of a premium or discount. Gain or loss that has already been recognized in profit or loss should not be reversed. Therefore, in the above example, the loss of €300 recognized previously would not be reversed through profit or loss, either on reclassification or in future, except through adjustments to interest income.

Any reclassified instruments are subsequently tested for impairments in accordance with the IAS 39 impairment requirements for the categories into which they are reclassified. For example, any subsequent changes in fair value of an instrument reclassified into the available-for-sale category (other than amortization of interest using the new effective interest rate) from the date of reclassification will be recorded in other comprehensive income and accumulated in equity as revaluation surplus until the instrument is derecognized or impaired.

The effective date of the amended IAS 39 was July 1, 2008, several months earlier than the October 2008 date on which the amendment was finalized. Reclassifications before this date were not permitted; so with the first application of the amended standard, entities were able to reclassify instruments as of July 1, 2008.

### ***Reclassifications from the held-to-maturity to available-for-sale category***

IAS 39 requires that a held-to-maturity investment must be reclassified as available-for-sale and remeasured at fair value as of the date of transfer if there is a change of intent or ability. Note that this may well be at an interim date, and fair value as of the next reporting date would not necessarily suffice to gauge the gain or loss to be recognized. Transfers from the held-to-maturity category to available-for-sale are measured at fair value at the date of transfer with the difference between the financial instrument’s carrying amount and fair value recognized in other comprehensive income (and accumulated in equity).

Reclassifications out of the held-to-maturity category may jeopardize all other similar classifications. The IGC has addressed the issue of whether such a reclassification might call into question the classification of other held-to-maturity investments. It finds that such reclassifications could well raise the spectre of having to reclassify all similarly categorized investments. IAS 39’s requirements concerning early sales of some held-to-maturity

investments apply not only to sales, but also to transfers of such investments. The term “transfer” comprises any reclassification out of the held-to-maturity category. Thus, the transfer of more than an insignificant portion of held-to-maturity investments into the available-for-sale category would not be consistent with an intention to hold other held-to-maturity investments to maturity.

Consequently, investments classified as held-to-maturity may be mandatorily reclassified to available-for-sale if the entity, during the current year or the two prior years, has sold, transferred, or exercised a put option on more than an insignificant amount of similarly classified instruments before maturity date. However, sales very close to the maturity dates (or exercised call dates) will not “taint” the classification of other held-to-maturity financial assets, nor will sales occurring after substantially all of the asset’s principal has been collected (e.g., in the case of serial bonds or mortgage instruments), or when made in response to isolated events beyond the entity’s control (e.g., the debtor’s impending financial collapse) when non-recurring in nature and not subject to having been forecast by the entity.

#### ***Reclassification from the available-for-sale to held-to-maturity category***

An entity is permitted, as a result of a change in intention or ability and because the two-year “tainting period” has passed, to reclassify any financial assets from the available-for-sale category to the held-to-maturity category. Transfers from the available-for-sale to the held-to-maturity category are measured at fair value at the date of transfer with the fair value on the date of reclassification becoming the amortized cost.

#### ***Reclassifications from the available-for-sale category to cost***

Any financial asset classified as available-for-sale that does not have a quoted market price in an active market nor a fair value that can be reliably measured will of necessity be carried at cost, unless there is evidence of impairment in value. Furthermore, on the date when a quoted price in active markets becomes available or its fair value can be reliably measured, the financial asset must be reclassified to the available-for-sale category, with changes in fair value recognized in other comprehensive income and accumulated in equity.

Fair value through profit or loss	Loans and receivables	Available-for-sale	Held-to-maturity
Derivatives (no reclassification)		←	→
Designated initially (no reclassification)			←
Held for trading	→	→	→

**Example**

To illustrate, a 20-year bond is issued at €10,000,000, which is the principal (i.e., par) amount. The debt requires quarterly interest payments equal to current three-month LIBOR plus 1% over the life of the instrument. The interest rate reflects the market-based required rate of return associated with the bond issue at issuance. Subsequent to issuance, the credit quality of the issuer deteriorates, resulting in a bond rating downgrade. Thereafter, the bond trades at a significant discount. Columbia Co. purchases the bond for €9,500,000 and classifies it as held-to-maturity. In this case, the discount of €500,000 is amortized to profit or loss over the period to the maturity of the bond. The discount is not amortized to the next date interest rate payments are reset. At each reporting date, Columbia assesses the likelihood that it will not be able to collect all amounts due (principal and interest) according to the contractual terms of the instrument, to determine the need for recognizing an impairment loss as a charge against profit or loss.

With the foregoing principles in mind, a basic example of the accounting for investments in equity instruments is next presented.

**Example of accounting for investments in equity instruments**

Assume that Raphael Corporation acquires the following equity instruments for investment purposes during 20XX:

<u>Security description</u>	<u>Acquisition cost</u>	<u>Fair value at year-end</u>
1,000 shares Belarus Steel common stock	€ 34,500	€ 37,000
2,000 shares Wimbledon pfd. "A" share	125,000	109,500
1,000 shares Hillcrest common stock	74,250	88,750

Assume that, at the respective dates of acquisition, management of Raphael Corporation designated the Belarus Steel and Hillcrest common stock investments as being for trading purposes, while the Wimbledon preferred shares were designated as having been purchased for long-term investment purposes (and will thus be categorized as available-for-sale rather than trading). Accordingly, the entries to record the purchases were as follows:

Investment in equity instruments—held-for-trading	108,750	
Cash		108,750
Investment in equity instruments—available-for-sale	125,000	
Cash		125,000

At year-end, both portfolios are adjusted to fair value; the decline in Wimbledon preferred share, series A, is judged to be a temporary market fluctuation because there is no objective evidence of impairment. The entries to adjust the investment accounts at December 31, 20XX are as follows:

Investment in equity instruments—held-for-trading	17,000	
Gain on holding equity instruments		17,000
Unrealized loss on equity instruments (OCI)—available-for-sale (other comprehensive income account)	15,500	
Investment in equity instruments—available-for-sale		15,500

Thus, the change in value of the portfolio of trading financial assets is recognized in profit or loss, whereas the change in the value of the available-for-sale financial assets is reflected in other comprehensive income and accumulated in equity.

**Notes and Bonds**

Non-current liabilities generally take one of two forms: notes or bonds. *Notes* generally represent debt issued to a single investor without intending for the debt to be broken up

among many investors. Their maturity, usually lasting one to seven years, tends to be shorter than that of a bond. *Bonds* also result from a single agreement. However, a bond is intended to be broken up into various subunits, for example, €1,000 (or equivalent) each, which can be issued to a variety of investors.

Notes and bonds share common characteristics: a written agreement stating the amount of the principal, the interest rate, when the interest and principal are to be paid, and the restrictive covenants, if any, that must be met. The interest rate is affected by many factors including the cost of money, the business risk factors, and the inflationary expectations associated with the business.

### *Nominal vs. effective rates*

The stated rate on a note or bond often differs from the market rate at the time of issuance. When this occurs, the present value of the interest and principal payments will differ from the maturity, or face value. If the market rate exceeds the stated rate, the cash proceeds will be less than the face value of the debt because the present value of the total interest and principal payments discounted back to the present yields an amount that is less than the face value. Because an investor is rarely willing to pay more than the present value, the bonds must be issued at a discount. The discount is the difference between the issuance price (present value) and the face, or stated, value of the bonds. This discount is then amortized over the life of the bonds to increase the recognized interest expense so that the total amount of the expense represents the actual bond yield.

When the stated rate exceeds the market rate, the bond will sell for more than its face value (at a premium) to bring the effective rate to the market rate and will decrease the total interest expense. When the market and stated rates are equivalent at the time of issuance, no discount or premium exists and the instrument will sell at its face value. Changes in the market rate subsequent to issuance are irrelevant in determining the discount or premium or the amount of periodic amortization.

Notes are a common form of exchange in business transactions for cash, property, goods and services. Most notes carry a stated rate of interest, but it is not uncommon for non-interest-bearing notes or notes bearing an unrealistic rate of interest to be exchanged. Notes such as these, which are long-term in nature, do not reflect the economic substance of the transaction since the face value of the note does not represent the present value of the consideration involved. Not recording the note at its present value will misstate the cost of the asset or services to the buyer, as well as the selling price and profit to the seller. In subsequent periods, both the interest expense and revenue will be misstated.

In general, the transaction price (cash, or the fair value of any non-cash consideration) will define the fair value of a financial instrument, including liabilities, at initial recognition. For most liabilities, this will be equivalent to the present value of all associated contractual cash flows, discounted at the relevant interest rate. However, when part of the consideration is other than the instrument, fair value may be estimated using a valuation technique (e.g., option pricing models). When a long-term loan is received which bears no interest or a non-market rate of interest, the present value must be computed with reference to contractual cash flows and current market rates. Any extra amount given is reflected in current earnings unless some other asset has been obtained.

Accordingly, it is suggested that all commitments to pay (and receive) money at a determinable future date be subjected to present value calculations and, if necessary, interest imputation, with the exceptions of the following:



1. Normal accounts payable due within one year.
2. Amounts to be applied to purchase price of goods or services or that provide security to an agreement (e.g., advances, progress payments, security deposits and retainages).
3. Obligations payable at some indeterminable future date (warranties).
4. Lending and depositor savings activities of financial institutions whose primary business is lending money.
5. Transactions where interest rates are affected by prescriptions of a governmental agency (e.g., revenue bonds, tax exempt obligations, etc.).

**Notes issued solely for cash**

When a note is issued solely for cash, its present value is assumed to be equal to the cash proceeds. The interest rate is that rate which equates the cash proceeds to the amounts to be paid in the future (i.e., *no* interest rate is to be imputed). For example, a €1,000 note due in three years that sells for €889 has an implicit rate of 4% ( $€1,000 \times .889$ , where .889 is the present value factor of a lump sum at 4% for three years). This rate is to be used when amortizing the discount.

**Non-cash transactions**

When a note is issued for consideration such as property, goods or services, and the transaction is entered into at arm's length, the stated interest rate is presumed to be fair unless (1) no interest rate is stated; (2) the stated rate is unreasonable; or (3) the face value of the debt is materially different from the consideration involved or the current market value of the note at the date of the transaction. As discussed above, it is recommended that when the rate on the note is not considered fair, the note is to be recorded at the fair market value of the property, goods or services received or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. When this amount differs from the face value of the note, the difference is to be recorded as a discount or premium and amortized to interest expense.

**Example of accounting for a note exchanged for property**

1. Alpha sells Beta a machine that has a fair market value of €7,510.
2. Alpha receives a three-year non-interest-bearing note having a face value of €10,000.

In this situation, the fair market value of the consideration is readily determinable and thus represents the amount at which the note is to be recorded. The following entry is necessary:

Machine	7,510	
Discount on notes payable	2,490	
Notes payable		10,000

The discount will be amortized to interest expense over the three-year period using the interest rate implied in the transaction.

If the fair market value of the consideration or note is not determinable, the present value of the note must be determined using an *imputed* interest rate. This rate will then be used to establish the present value of the note by discounting all future payments on the note at this rate. General guidelines for imputing the interest rate include the prevailing rates of similar instruments from creditors with similar credit ratings and the rate the

debtor could obtain for similar financing from other sources. Other determining factors include any collateral or restrictive covenants involved, the current and expected prime rate, and other terms pertaining to the instrument. The objective is to approximate the rate of interest that would have resulted if an independent borrower and lender had negotiated a similar transaction under comparable terms and conditions. This determination is as of the issuance date, and any subsequent changes in interest rates would be irrelevant.

Bonds represent a promise to pay a sum of money at a designated maturity date plus periodic interest payments at a stated rate. Bonds are used primarily to borrow funds from the general public or institutional investors when a contract for a single amount (a note) is too large for one lender to supply. Dividing up the amount needed into €1,000 or €10,000 units makes it easier to sell the bonds.

In most situations, a bond is issued at a price other than its face value. The amount of the cash exchanged is equal to the total of the present value of the interest and principal payments. The difference between the cash proceeds and the face value is recorded as a premium if the cash proceeds are greater or a discount if they are less. The journal entry to record a bond issued at a premium follows:

Cash	(proceeds)	
Premium on bonds payable		(difference)
Bonds payable		(face value)

The premium will be recognized over the life of the bond issue. If issued at a discount, “Discount on bonds payable” would be debited for the difference. As the premium is amortized, it will reduce interest expense on the books of the issuer (a discount will increase interest expense). The premium (discount) would be added to (deducted from) the related liability when a statement of financial position is prepared.

The *effective interest method* is the prescribed method of accounting for a discount or premium arising from a note or bond, although some other method may be used (e.g., straight-line) if the results are not materially different. Under the effective interest method, the discount or premium is to be amortized over the life of the debt so as to produce a constant rate of interest when applied to the amount outstanding at the beginning of any given period. Therefore, interest expense is equal to the market rate of interest at the time of issuance multiplied by this beginning figure. The difference between the interest expense and the cash paid represents the amortization of the discount or premium. The effective rate is a required disclosure under IAS 32.

As with other aspects of financial reporting requirements, if alternative methods do not result in material disparities versus the prescribed approaches to measurement, they may also be used. Interest expense under the *straight-line method* is equal to the cash interest paid plus the amortized portion of the discount or minus the amortized portion of the premium. The amortized portion is equal to the total amount of the discount or premium divided by the life of the debt from issuance in months multiplied by the number of months the debt has been outstanding that year.

#### Example of applying the effective interest method

1. A three-year, 12%, €10,000 bond is issued at 1/1/20XX with interest payments due semi-annually.
2. The market rate is 10%.

The amortization table would appear as follows:

<u>Date</u>	<u>Credit</u> <u>cash</u>	<u>Debit</u> <u>int. exp.</u>	<u>Debit</u> <u>premium</u>	<u>Unamortized</u> <u>prem. bal.</u>	<u>Carrying</u> <u>Value</u>
1/1/20XX				€507.61	€10,507.61 <sup>a</sup>
7/1/20XX	€ 600.00 <sup>b</sup>	€ 525.38 <sup>c</sup>	€ 74.62 <sup>d</sup>	432.99 <sup>e</sup>	10,432.99 <sup>f</sup>
1/1/20XX+1	600.00	521.65	78.35	354.64	10,354.64
7/1/20XX+1	600.00	517.73	82.27	272.37	10,272.37
1/1/20XX+2	600.00	513.62	86.38	185.99	10,185.99
7/1/20XX+2	600.00	509.30	90.70	95.29	10,095.29
1/1/20XX+3	600.00	504.71 <sup>g</sup>	95.29	=	<u>€10,000.00</u>
	<u>€3,600.00</u>	<u>€3,092.39</u>	<u>€507.61</u>		

(a) PV of principal and interest payments

$$\begin{aligned} €10,000(.74622) &= € 7,462.20 \\ € 600(5.07569) &= \quad 3,045.41 \\ &\quad \underline{\underline{€10,507.61}} \end{aligned}$$

(b) €10,000.00 × .06

(c) €10,507.61 × .05

(d) €600.00 − €525.38

(e) €507.61 − €74.62

(f) €10,507.61 − €74.62

(or €10,000 + €432.99)

(g) Rounding error = € .05

When the interest date does not coincide with the year-end, an adjusting entry must be made. The proportional share of interest payable should be recognized along with the amortization of the discount or premium. Within the amortization period, the discount or premium can be amortized using the straight-line method, as a practical matter, or can be computed more precisely as described above.

If the bonds are issued between interest dates, discount or premium amortization must be computed for the period between the sale date and the next interest date. This is accomplished by “straight-lining” the period’s amount calculated using the usual method of amortization. In addition, the purchaser prepays the seller the amount of interest that has accrued since the last interest date. This interest is recorded as a payable by the seller. At the next interest date, the buyer then receives the full amount of interest regardless of how long the bond has been held. This procedure results in interest being paid equivalent to the time the bond has been outstanding.

Various costs may be incurred in connection with issuing bonds. Examples include legal, accounting, and underwriting fees; commissions; and engraving, printing and registration costs. These costs should be deducted from the initial carrying amount of the bonds and amortized using the effective interest method; generally the amount involved is insignificant enough that use of the simpler straight-line method would not result in a material difference. These costs do not provide any future economic benefit and therefore should not be considered an asset. Since these costs reduce the amount of cash proceeds, they in effect increase the effective interest rate and probably should be accounted for the same as an unamortized discount. Current liabilities that are expected to be refinanced on a long-term basis, and that accordingly are classified as non-current liabilities according to IAS 1, are discussed in Chapter 18.

## Impairments and Uncollectibility

### Accounting for impairments—general concerns

A financial asset or group of financial assets (except those carried at FVTPL) need to be assessed at the end of each reporting period, whether there is any objective evidence that the

**Table 2. Measurement of Impairment Losses**

<u>Financial assets carried at</u>	<u>Measurement of impairment loss</u>
Amortized cost (Loans & receivables; Held-to-maturity)	Difference between the carrying amount and the present value of expected future cash flows, discounted using the instrument's original discount rate
Fair value (Available-for-sale)	Difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss previously recognized in profit or loss
<u>Financial assets carried at</u>	<u>Measurement of impairment loss</u>
Cost (Fair value cannot be reliably measured)	Difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for similar financial asset

assets are impaired. This is to be assessed as a result of one or more events that occurred after the initial recognition of the asset (a “loss event”) and that loss event (or events) impacts the estimated future cash flows of the financial asset(s) that can be reliably estimated. Loss events include any significant financial difficulties of the issuer, a contractual breach (default or delinquency) by the issuer, the probability of a bankruptcy or financial reorganization, or the disappearance of an active market for the issuer's instruments (although the fact that an entity has “gone private” does not create the presumption of impairment).

If there is an objective evidence of impairment, measurement of impairment losses presented in Table 2 is as follows.

For financial assets being reported at amortized cost (those held to maturity, plus loans or receivables originated by the entity), the amount of the impairment to be recognized is the difference between the carrying amount and the present value of expected future cash flows, discounted using the instrument's original discount rate. Unquoted equity instruments carried at cost (because its fair value cannot be reliably measured) are also tested for impairment and the amount of impairment loss is calculated as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for similar financial asset. If a decline in the fair value of an available-for-sale financial asset has been recognized in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative impairment loss should be reclassified from equity to profit or loss.

### ***Evidence of impairment***

A financial asset (or a group of assets) is impaired only if there is objective evidence of impairments as a result of one or more events that occurred after the initial recognition of the asset (which IAS 39 calls a “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset (or group of assets) that can be reliably estimated. Losses that are anticipated to occur as a result of future events, no matter how likely this may appear to be, cannot be given current recognition. (This is consistent with guidance on provisions and contingencies under IAS 37.)

In practice, it may not be possible to identify a single, specific event that causes an impairment. Rather, the combined effect of several events may be the cause. Revised IAS 39 does offer a useful tabulation of such factors, however. These include the following matters:

1. Significant financial difficulty of the issuer or obligor;
2. A default or delinquency in interest or principal payments, or other breach of contract by the borrower;
3. The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting an otherwise unlikely concession to the borrower;
4. A growing likelihood that the borrower will enter bankruptcy or reorganize;
5. The elimination of an active market for the asset because of financial difficulties; or
6. Observable data about 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 financial assets in the group, including:
  - a. Adverse changes in the payment status of borrowers in the group (e.g., an increased number of late payments; increased frequency of credit card borrowers reaching their credit limits and that are paying monthly minimums); or
  - b. National or local economic indicators that correlate with defaults on the assets in the group (e.g., increased unemployment rate in the geographical area of the borrowers; decreased property prices (for mortgage assets); decreased commodity prices (for loans to commodity producers); adverse changes in other industry conditions).

In addition to the above loss events, objective evidence of impairment for an investment in an equity instrument includes information about changes in technological, economic and legal environments. A significant or prolonged decline in the fair value of an investment in equity instruments below its cost may also constitute objective evidence of impairment.

The disappearance of an active market because an entity's financial instruments are no longer publicly traded, and a decline in the fair value of a financial asset below its cost or amortized cost, is not necessarily evidence of impairment, although it may be evidence of impairment when considered with other available information. In some cases experienced professional judgement must be used to estimate the amount of impairment losses, for example when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers.

Impairments of financial assets is one of the issues that the IASB is addressing in the second phase of its project to replace IAS 39. The current impairment approach under the *incurred loss* model could be replaced by another model, such as *expected loss* model.

### ***Impairment of financial assets carried at amortized cost***

IAS 39 requires that impairment be recognized for financial assets carried at amortized cost (loans and receivables or held-to-maturity investments) if there is objective evidence that an impairment has incurred. That impairment may be measured and recognized individually or, for a group of similar financial assets, on a portfolio basis. As noted above, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Future credit losses that have not been incurred cannot be included in this computation (again, the concepts underlying IAS 37 must be observed). The original effective rate is not the nominal or contractual rate of the debt, but rather is the effective interest rate computed at the date of initial recognition of the investment. If an impairment is determined to exist, the carrying amount of the asset may either be reduced directly or via the use of an allowance account. Any loss is to be recognized currently in profit or loss.

Where there is no ability to individually assess financial assets accounted for at amortized cost for impairment, IAS 39 directs that these assets be grouped and assessed on a portfolio basis. The following additional guidance is provided to evaluate impairment inherent in a group of loans, receivables or held-to-maturity investments that cannot be identified with any individual financial asset in the group:

- Assets individually assessed for impairment and found to be impaired should not be included in a group of assets that are collectively assessed for impairment.
- Assets individually assessed for impairment and found *not* to be individually impaired should be included in a collective assessment of impairment.
- When performing a collective assessment of impairment, an entity groups assets by similar credit risk characteristics.
- Expected cash flows are estimated based on contractual cash flows and historical loss experience (adjusted on the basis of relevant observable data reflecting current economic conditions).
- Impairment loss should not be recognized on the initial recognition of an asset.

A reversal of a previously recognized impairment is permitted when there is clear evidence that the reversal occurred subsequent to the initial impairment recognition and is the result of a discrete event, such as the improved credit rating of the debtor. This reversal is accounted for consistent with the impairment—that is, it is recognized in current period profit or loss. However, the amount of recovery recognition is limited, so that the new carrying value of the asset is no greater than what its carrying value would have been had the impairment not occurred, adjusted for any amortization over the intervening period.

For example, consider an asset that was carried at €8,000 and being accreted, at €500 per year; to a maturity value of €10,000 at the time it was found to be impaired and written down to €5,000. Two years later the credit-related problem was resolved and the fair value was assessed as €9,500. However, it can only be restored to a carrying value of €9,000, which is what would have been the carrying value had two further years' amortization (at €500 per year) been accreted.

If an asset has been individually assessed for impairment and was found not to be individually impaired, according to IAS 39 it should be included in the collective assessment of impairment. According to the standard, this is to reflect that, in the light of the law of large numbers, impairment may be evident in a group of assets, but not yet meet the threshold for recognition when any individual asset in that group is assessed.

However, it is not permissible to avoid addressing impairment on an individual asset basis in order to use group assessment, in a deliberate effort to benefit from the implicit offsetting described above. If one asset in the group is impaired but the fair value of another asset in the group is above its amortized cost, non-recognition of the impairment of the first asset is not permitted. If it is known that an individual financial asset carried at amortized cost is impaired, IAS 39 requires that the impairment of that asset be recognized. Measurement of impairment on a portfolio basis under IAS 39 is applicable *only* when there is indication of impairment in a group of similar assets, and impairment cannot be identified with an individual asset in that group.

In actually assessing impairment on a portfolio basis (a “collective assessment of impairment”), care should be taken to include only assets having similar credit risk characteristics, indicative of the debtors' ability to pay all amounts due according to the contractual terms. While contractual cash flows and historical loss experience will provide a

basis for estimating *expected* cash flows, these historical data must be adjusted for relevant observable data reflecting current (i.e., as of the end of the reporting period) economic conditions.

IAS 39 further cautions that whatever methodology is used to measure impairment, it should ensure that an impairment loss is not recognized at the initial recognition of an asset. Put another way, the imputed interest rate on a newly acquired debt instrument should be the rate that equates the net carrying amount of the financial instrument and the present value of future cash flows, and this rate is used consistently thereafter in valuing the asset as future cash flow expectations change. An impairment on “day one” thus cannot exist, and would indicate an error in methodology should it occur.

### *Assessment and recognition of loan impairment*

If a loan and receivable with fixed interest rate payments is hedged against the exposure to interest rate risk by a “receive-variable, pay-fixed” interest rate swap, the hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. According to an interpretive finding by the IGC, an assessment of impairment in the loan should take into account the fair value adjustment for interest rate risk. Since the loan’s original effective interest rate prior to the hedge is made irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements, the original effective interest rate and amortized cost of the loan are adjusted to take into account recognized fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan. An impairment loss on the hedged loan should therefore be calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the expected future cash flows of the loan discounted at the adjusted effective interest rate.

Assume that, due to financial difficulties of Knapsack Co., one of its customers, the Galactic Bank, becomes concerned that Knapsack will not be able to make all principal and interest payments due on a loan and receivable when they become due. Galactic negotiates a restructuring of the loan, and it now expects that Knapsack will be able to meet its obligations under the restructured terms. Whether Galactic Bank will recognize an impairment loss—and in what magnitude—will depend, according to the IGC, on the specifics of the restructured terms. The IGC offers the following guidelines.

If, under the terms of the restructuring, Knapsack Co. will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms, an impairment must be recognized, since the present value of the future principal and interest payments discounted at the loan’s original effective interest rate (i.e., the recoverable amount) will be lower than the carrying amount of the loan.

If, on the other hand, Knapsack Co.’s restructuring agreement calls for it to pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms, the same result as the foregoing will again hold. The impairment will be measured as the difference between the former carrying amount and the present value of the future principal and interest payments discounted at the loan’s original effective interest rate.

As yet another variation on the restructuring theme, if Knapsack will pay the full principal amount on the original due date with interest, only at a lower interest rate than the interest rate inherent in the original loan, again the same guidance is offered by the IGC, so that an impairment must be recognized.

This same outcome prevails if Knapsack agrees to pay the full principal amount five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term. Since the present value of future cash flows is lower than the loan's carrying amount, impairment is to be recognized.

As a final option, the IGC offers the loan restructuring situation whereby Knapsack is to pay the full principal amount five years after the original due date and all interest, including interest for both the original term of the loan and the extended term. In this scenario, even though the amount and timing of payments has changed, Galactic Bank will nonetheless receive interest on interest, so that the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss.

### ***Impairment of financial assets carried at cost***

Impairment losses on unquoted equity instruments that are not carried at fair value because the fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, are recognized if there is objective evidence that impairment losses have occurred. These are measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Note that current rates, not the original effective rate, are the relevant reference, since these investments were being maintained at cost by default (i.e., due to the absence of reliable fair value data), not because they qualified for amortized cost due to being held to maturity. Accordingly, the application of fair value accounting, or a reasonable surrogate for it, is valid in such instances. No reversals of prior impairment losses are allowed for financial assets measured at cost.

### ***Impairment of financial assets carried at fair value***

The fair value of an equity security that is classified as available-for-sale may fall below its carrying amount and that is not necessarily evidence of impairment. When an entity reports fair value changes on available-for-sale financial assets in other comprehensive income and equity in accordance with IAS 39, it continues to do so until there is objective evidence of impairment, such as the circumstances identified in the standard. If objective evidence of impairment exists, any cumulative fair value losses that have been recognized in other comprehensive income should be reclassified from equity to profit or loss for the period. As discussed above, it is essential to carefully consider significant declines in fair value, including recurring annual declines to assess whether these represent objective evidence of impairment.

The amount of the cumulative impairment loss that is reclassified from equity to profit or loss is the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss previously recognized in profit or loss.

Reversals of impairment losses recognized in profit or loss for an investment in *equity* instruments are *not* allowed. Since no reversal of the impairment loss is allowed for equity instruments, so that, if subsequent to impairment recognition there is an increase in the fair value of the available-for-sale investment, that increase is recognized in other comprehensive income and not in profit or loss.

Reversals of impairment losses recognized in profit or loss for an investment in *debt* instruments should be reversed, with the amount of the reversal recognized in profit or loss if the increase in the fair value is objectively linked to an event occurring after the impairment loss was recognized.



No assessment of impairment is conducted for investments in debt and equity instruments classified as at FVTPL since these instruments are valued at fair value with mark-to-market adjustments recognized in profit or loss.

IFRIC 10, *Interim Financial Reporting and Impairment*, addressing conflicts between the requirements of IAS 34, *Interim Financial Reporting*, and those in other standards on the recognition and reversal in the financial statements of impairment losses in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost under IAS 39, states that any impairment losses recognized in an interim financial statement must not be reversed in subsequent interim or annual financial statements.

#### Example of impairment of investments

Given the foregoing, assume now, with reference again to the Raphael Corporation example first presented earlier in this chapter, that in January 20XX new information comes to Raphael Corporation management regarding the viability of Wimbledon Corp. Based on this information, it is determined that the decline in Wimbledon preferred share is probably not a temporary one, but rather is an impairment of the asset as that term is used in IAS 39. The standard prescribes that such a decline be reflected in profit or loss. The share's fair value has remained at the amount last reported, €109,500, but this value is no longer viewed as being only a market fluctuation. Accordingly, the entry to recognize the fact of the investment's permanent impairment is as follows:

Impairment loss on holding equity instruments	15,500	
Unrealized loss on equity instruments—available-for-sale (other comprehensive income)		15,500

Any later recovery of impairment losses on available-for-sale equity instruments cannot be reversed. Later market fluctuations will be reported in other comprehensive income.

To illustrate this point, assume that in March 20XX new information comes to management's attention, which suggests that the decline in Wimbledon preferred had indeed been only a temporary decline; in fact, the value of Wimbledon now rises to €112,000. It would not be permitted under revised IAS 39 to reverse the impairment loss that had been included in profit or loss. The carrying value after the recognition of the impairment was €109,500, and the current period increase to €112,000 will have to be accounted for as an increase to be reflected in other comprehensive income, rather than in profit or loss. The entry required to reflect this is:

Investment in equity instruments—available-for-sale	2,500	
Unrealized gain on equity instruments—available-for-sale (other comprehensive income)		2,500

However, if this investment is a debt instrument classified as available-for-sale, evidence of any specific event occurring after the date of the impairment loss recognized in profit or loss that is responsible for this recovery in value can be reversed through profit or loss. Any increases in value above the original cost basis would not be taken into profit or loss, but rather recognized in other comprehensive income, since the investment is classified as available-for-sale.

#### *Structured notes as held-to-maturity investments*

Among the more complex of what are commonly referred to as “engineered” financial products, which have become commonplace over the last decade, are “structured notes.” Structured notes and related products are privately negotiated and not easily marketable once acquired. These instruments often appear to be straightforward debt investments, but in fact contain provisions which have the potential to greatly increase or decrease the return to the

investor, based on (typically) the movement of some index related to currency exchange rates, interest rates, or, in some cases, share price indices. The IGC has addressed the question of whether these assets can be considered as held-to-maturity investments. The IGC offers as an example a structured note tied to an equity price index, upon which the following illustration is based.

**Example of structured debt instrument**

Cartegena Co. purchases a five-year “equity-index-linked note” with an original issue price of €1,000,000 at its market price of €1,200,000 at the time of purchase. The note requires no interest payments prior to maturity. At maturity, the note requires payment of the original issue price of €1,000,000 plus a supplemental redemption amount that depends on whether a specified share price index (e.g., the Dow Jones Industrial Average) exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount will equal 115% of the difference between the level of the share index at maturity and the level of the share index at original issuance of the note divided by the level of the share index at original issuance.

Obviously, the investment is largely a gamble on an increase in the Dow Jones average over the five-year term, since Cartegena is paying a substantial premium and, as a worst-case scenario, could lose its entire premium plus the opportunity cost of lost interest over the five years. Structured notes such as this are very difficult to dispose of on the secondary (i.e., resale) market, having been created (structured) to fit the unique needs or desires of the issuer and investor. Determining a fair value at any intermediate point in the five-year holding period would be difficult or impossible, absent arm’s-length bids, particularly if the underlying index has yet to advance to a level at which a gain will be reaped by the investor.

In the present example, assume that Cartegena has the positive intent and ability to hold the note to maturity. According to guidance issued by the IGC, it can indeed classify this note as a held-to-maturity investment, because it has a fixed payment of €1,000,000 and a fixed maturity, and because Cartegena Co. has the positive intent and ability to hold it to maturity. However, the equity index feature is a call option not closely related to the debt host, and accordingly, it must be separated as an embedded derivative under IAS 39. The purchase price of €1,200,000 must be allocated between the host debt instrument and the embedded derivative. For instance, if the fair value of the embedded option at acquisition is €400,000, the host debt instrument is measured at €800,000 on initial recognition. In this case, the discount of €200,000 that is implicit in the host bond is amortized to net profit or loss over the term to maturity of the note using the effective interest method.

A similar situation arises if the investment is a bond with a fixed payment at maturity and a fixed maturity date, but with variable interest payments indexed to the price of a commodity or equity (commodity-indexed or equity-indexed bonds). If the entity has the positive intent and ability to hold the bond to maturity, it can be classified as held-to-maturity. However, as confirmed in an interpretation offered by the IGC, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value. The special exception in IAS 39, under which, if the two components cannot be reasonably separated the entire financial asset is classified as held for trading purposes, is found not to be applicable. According to the IGC, it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

***Accounting for sales of investments in financial instruments***

In general, sales of investments are accounted for by eliminating the carrying value and recognizing a gain or loss for the difference between carrying amount and sales proceeds.

Derecognition will occur only when the entity transfers control over the contractual rights which comprise the financial asset, or a portion thereof. IAS 39 sets forth certain conditions to define an actual transfer of control. Thus, for example, in most cases if the transferor has the right to reacquire the transferred asset, derecognition will not be warranted, unless the asset is readily obtainable in the market or reacquisition is to be at then-fair value. Arrangements which are essentially repurchase (repo) arrangements are similarly not sales and do not result in derecognition. In general, the transferee must obtain the benefits of the transferred asset in order to warrant derecognition by the transferor.

In accordance with IAS 39 there are two main concepts—risks and rewards, and control—that govern derecognition decisions. However, the standard clarifies that evaluation of the transfer of risks and rewards of ownership must in all instances precede the evaluation of the transfer of control (see discussion in the paragraph, “Derecognition of Financial Assets” earlier in this chapter).

In some instances, the asset will be sold as part of a compound transaction in which the transferor either retains part of the asset, obtains another financial instrument or incurs a financial liability. If the fair values of all components of the transaction (asset retained, new asset acquired, etc.) are known, computing the gain or loss will be no problem. However, if one or more elements are not subject to an objective assessment, special requirements apply. In the unlikely event that the fair value of the component retained cannot be determined, it should be recorded at zero, thereby conservatively measuring the gain (or loss) on the transaction. Similarly, if a new financial asset is obtained and it cannot be objectively valued, it must be recorded at zero value.

On the other hand, if a financial liability is assumed (e.g., a guarantee) and it cannot be measured at fair value, then the initial carrying amount should be such (i.e., large enough) that no gain is recognized on the transaction. If necessitated by IAS 39’s provisions, a loss should be recognized on the transaction. For example, if an asset carried at €4,000 is sold for €4,200 in cash, with the transferor assuming a guarantee obligation which cannot be valued (admittedly, such a situation is unlikely to occur in the context of a truly “arm’s-length” transaction), no gain would be recognized and the financial liability would accordingly be initially recorded at €200. On the other hand, if the selling price were instead only €3,800, a loss of €200 would be immediately recognized, and the guarantee obligation would be given no value (but would be disclosed).

### **Accounting for Hedging Activities**

The topic of hedging is almost inextricably intertwined with the subject of financial derivatives, since most (but not all) hedging is accomplished using derivatives. Revised IAS 39 addresses both of these matters extensively, and the IGC has provided yet more instructional materials on these issues. In the following sections, a basic review of, first, derivative financial instruments, and second, hedging activities, will be presented.

#### ***Derivatives***

As defined by IAS 39, a derivative is a financial instrument with all the following characteristics:

1. Its value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the underlying);

2. It requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
3. It is settled at a future date.

The definition is important because it is used in determining the classification and measurement of financial instruments. If any FI meets the above definition it is classified as FVTPL unless the instrument is designated as a hedging instrument.

The underlying variable is that variable that will determine the settlement of a derivative (with a notional amount or a payment provision).

Examples of financial instruments that meet the foregoing definition include the following, along with the underlying variable which affects the derivative's value.

<u>Type of contract</u>	<u>Main pricing—settlement variable (underlying variable)</u>
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap (equity of another entity)	Equity prices
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written share option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

The issue of what is meant by “little or no net investment” has been explored by the IGC. According to the IGC, professional judgement will be required in determining what constitutes little or no initial net investment, and is to be interpreted on a relative basis—the initial net investment is less than that needed to acquire a primary financial instrument with a similar response to changes in market conditions. This reflects the inherent leverage features typical of derivative agreements compared to the underlying instruments. If, for example, a “deep in the money” call option is purchased (that is, the option's value consists mostly of intrinsic value), a significant premium is paid. If the premium is equal or close to the amount required to invest in the underlying instrument, this would fail the “little initial net investment” criterion.

A margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearinghouse and may take the form of cash, instruments or other specified assets, typically liquid ones. Margin accounts

are separate assets that are to be accounted for separately. Accordingly, in determining whether an arrangement qualifies as a derivative, the margin deposit is not a factor in assessing whether the “little or no net investment” criterion has been met.

A financial instrument can qualify as a derivative even if the settlement amount does not vary proportionately. An example of this phenomenon was provided by the IGC.

#### Example of derivative transaction

Accurate Corp. enters into a contract that requires it to pay Aimless Co. €2 million if the share of Reference Corp. rises by €5 per share or more during a six-month period. Conversely, Accurate Corp. will receive from Aimless Co. a payment of €2 million if the share of Reference Corp. declines by €5 or more during that same six-month period. If price changes are within the  $\pm$  €5 collar range, no payments will be made or received by the parties. This arrangement would qualify as a derivative instrument, the underlying being the price of Reference Corp. common share. IAS 39 provides that “a derivative could require a fixed payment as a result of some future event that is unrelated to a notional amount.”

In some instances what might first appear to be normal financial instruments are actually derivative transactions. The IGC offers the example of offsetting loans, which serve the same purpose and should be accounted for as an interest rate swap. The example is as follows:

#### Example of apparent loans that qualify as derivative transaction

Aguilar S.A. makes a five-year *fixed-rate* loan to Battapaglia Spa, while Battapaglia at the same time makes a five-year *variable-rate* loan for the same amount to Aguilar. There are no transfers of principal at inception of the two loans, since Aguilar and Battapaglia have a netting agreement. While superficially these appear to be two unconditional debt obligations, in fact this meets the definition of a derivative. Note that there is an underlying variable, no or little initial net investment, and future settlement, such that the contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative.

Indicators of this situation would include (1) the transactions are entered into at the same time and in contemplation of one another; (2) they have the same counterparty; (3) they relate to the same risk; and (4) there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction. Note that even in the absence of a netting agreement, the foregoing arrangement would have been deemed to be a derivative.

Another example of this is debt instruments that include options for early settlement (prepayments), puts or calls which allow either party to terminate the contract before maturity. Such options comprise derivatives (embedded derivatives as defined below) which may need to be separately accounted for from the underlying debt instrument (see below for further guidance in this respect).

#### *Difficulty of identifying whether certain transactions involve derivatives*

The definition of derivatives has already been addressed. While seemingly straightforward, the almost limitless and still expanding variety of “engineered” financial products often makes definitive categorization more difficult than this at first would appear to be.

The IGC illustrates this with examples of two variants on interest rate swaps, both of which involve prepayments. The first of these, a prepaid interest rate swap (fixed-rate payment obligation prepaid at inception or subsequently) qualifies as a derivative; the

second, a variable-rate payment obligation prepaid at inception or subsequently, would not be a derivative. The reasoning is set forth in the next paragraphs, which are adapted from the IGC guidance.

**Example of interest rate swap to be accounted for as a derivative**

First consider the “pay-fixed, receive-variable” interest rate swap that the party prepays at inception. Assume Agememnon Corp. enters into a €100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Baltic Metals, Inc. The interest rate of the variable part of the swap resets on a quarterly basis to the three-month LIBOR. The interest rate of the fixed part of the swap is 10% per year. Agememnon Corp. prepays its fixed obligation under the swap of €50 million (= €100 million × 10% × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the €100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires little initial net investment relative to other types of contracts that have a similar response to changes in market conditions, such as a variable-rate bond. Therefore, the contract fulfills the “no or little initial net investment” provision of IAS 39. Even though Agememnon Corp. has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is considered to be a derivative contract. The IGC further notes that if the fixed-rate payment obligation is prepaid subsequent to initial recognition, which would be considered a termination of the old swap and an origination of a new instrument, which would have to be evaluated under IAS 39.

Now consider the opposite situation, a prepaid pay-variable, receive-fixed interest rate swap, which the IGC concludes is *not* a derivative. This result obtains because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows.

**Example of interest rate swap *not* to be accounted for as a derivative**

Assume that Synchronous Ltd. enters into a €100 million notional amount five-year “pay-variable, receive-fixed” interest rate swap with counterparty Cabot Corp. The variable leg of the swap resets on a quarterly basis to the three-month LIBOR. The fixed interest payments under the swap are calculated as 10% times the swap’s notional amount, or €10 million per year. Synchronous Ltd. prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10% on €100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream, since Synchronous Ltd. knows it will receive €10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the “no or little net investment” criterion of IAS 39. Therefore, the contract is *not* to be accounted for as a derivative under IAS 39. By discharging the obligation to pay variable interest rate payments, Synchronous Ltd. effectively extends an annuity loan to Cabot Corp. In this situation, the instrument is accounted for as a loan originated by the entity unless Synchronous Ltd. has the intent to sell it immediately or in the short term.

In yet other instances arrangements that technically meet the definition of derivatives are not to be accounted for as such.

**Example of derivative not to be settled for cash**

Assume National Wire Products Corp. enters into a fixed-price forward contract to purchase two million kilograms of copper. The contract permits National Wire to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of an underlying, copper, and it is to be settled at a future date. However, if National Wire intends to settle the contract by taking delivery and has no history of settling in cash, the contract is not accounted for as a derivative under IAS 39. Instead, it is accounted for as an executory contract for the purchase of inventory.

This follows the provisions under IAS 39:5 & 6 under which contracts to buy or sell non-financial items will not be within the scope of financial instruments accounting when they were entered into, and continue to be held, for the purpose of the receipt of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

For example, Autoco Inc. enters into forward contracts to purchase steel for use in the manufacturing of motor vehicles. It has established past practice of settling such contracts through actual delivery and subsequent consumption of the steel within its manufacturing process. Such forward contracts will be excluded under the provisions of IAS 39:5 discussed above. Just as some seemingly derivative transactions may be accounted for as not involving a derivative instrument, the opposite situation can also occur, where some seemingly non-derivative transactions would be accounted for as being derivatives.

**Example of non-financial derivative to be settled for cash**

Argyle Corp. enters into a forward contract to purchase a commodity or other non-financial asset that contractually is to be settled by taking delivery. Argyle has an established pattern of settling such contracts prior to delivery by contracting with a third party. Argyle settles any market value difference for the contract price directly with the third party. This pattern of settlement prohibits Argyle Corp. from qualifying for the exemption based on normal delivery; the contract is accounted for as a derivative. IAS 39 applies to a contract to purchase a non-financial asset if the contract meets the definition of a derivative and the contract does not qualify for the exemption for delivery in the normal course of business. In this case, Argyle does not expect to take delivery. Under the standard, a pattern of entering into offsetting contracts that effectively accomplishes settlement on a net basis does not qualify for the exemption on the grounds of delivery in the normal course of business.

***Forward contracts***

Forward contracts to purchase, for example, fixed-rate debt instruments (such as mortgages) at fixed prices are to be accounted for as derivatives. They meet the definition of a derivative because there is no or little initial net investment, there is an underlying variable (interest rates), and they will be settled in the future. However, such transactions are to be accounted for as a regular-way transaction, if regular-way delivery is required. "Regular-way" delivery is defined by IAS 39 to include contracts for purchases or sales of financial instruments that require delivery in the time frame generally established by regulation or convention in the marketplace concerned. Regular-way contracts are explicitly defined as *not* being derivatives.

### ***Future contracts***

Future contracts are financial instruments that require delivery of a commodity, for example an equity instrument or currency, at a specified price agreed to on the contract inception date (exercise price), on a specified future date. Futures are similar to forward contracts except futures have standardized contract terms and are traded on organized exchanges.

### ***Options***

Options are contracts that give the buyer (option holder) the right, but not the obligation, to acquire from or sell to the option seller (option writer) a certain quantity of an underlying financial instrument or other commodity, at a specified price (the strike price) and up to a specified date (the expiration date). An option to buy is referred to as a “call”; an option to sell is referred to as a “put.”

### ***Swaps***

Interest rate (and currency) swaps have become widely used financial arrangements. Swaps are to be accounted for as derivatives whether an interest rate swap settles gross or net. Regardless of how the arrangement is to be settled, the three key defining characteristics are present in all interest rate swaps—namely, that value changes are in response to changes in an underlying variable (interest rates or an index of rates), that there is little or no initial net investment and that settlements will occur at future dates. Thus, swaps are always derivatives.

### ***Derivatives that are not based on financial instruments***

Not all derivatives involve financial instruments. Consider Corboy Co., which owns an office building and enters into a put option, with a term of five years, with an investor that permits it to put the building to the investor for €15 million. The current value of the building is €17.5 million. The option, if exercised, may be settled through physical delivery or net cash, at Corboy’s option. Corboy’s accounting depends on Corboy’s intent and past practice for settlement. Although the contract meets the definition of a derivative, Corboy does not account for it as a derivative if it intends to settle the contract by delivering the building if it exercises its option, and there is no past practice of settling net.

The investor, however, cannot conclude that the option was entered into to meet the investor’s expected purchase, sale or usage requirements because the investor does not have the ability to require delivery. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor’s intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has the choice of physical delivery or net cash settlement can never satisfy the normal delivery requirement for the exemption from IAS 39 for the investor. However, if the contract required physical delivery and the reporting entity had no past practice of settling net in cash, the contract would not be accounted for as a derivative.

**Net settlement:** Under IAS 39:6, net settlement can be achieved in many ways such as:

- a. Settling net through either cash or by exchanging financial instruments as set out under the contract;
- b. Having practice of settling net similar contracts even where the contract is not explicit on net settlement;



- c. Where delivery is actually taken, there is past practice and history of the entity taking delivery and selling it within a short period after delivery earning a profit similar to that of a dealer's margin; or
- d. The item that is subject to the contract being readily convertible to cash.

**Embedded derivatives** is a component of a hybrid instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to 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 the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative but a separate financial instrument.

A hybrid contract is the entire contract, within which there is an embedded derivative. A host contract on the other hand is the main body of the contract excluding the embedded derivative.

In certain cases, IAS 39 requires that an embedded derivative be separated from a host contract. The embedded derivative must then be accounted for separately as a derivative, at fair value. That does not, however, require separating them in the statement of financial position; IAS 39 does not address the presentation in the statement of financial position of embedded derivatives. However, IFRS 7 requires separate disclosure of financial assets carried at cost and financial assets carried at fair value, although this could be in the notes rather than in the statement of financial position.

#### Example of debt host contract

Company A issues a bond convertible into ordinary shares of Company B. The hybrid contract is the convertible bond, the host contract is the loan/bond, and the embedded derivative is the conversion option.

Lease host contract: If Company A has entered into a rental agreement with Company B. The increase in rent every year is dictated by the inflation RPI. The hybrid contract is the rental agreement lease, the host contract is the rental liability, and the embedded derivative is the retail price index.

If a hybrid contract contains a host that is not an asset within the scope of IAS 39, an embedded derivative shall be separated from the host and accounted for as a derivative if and only if:

- The economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the hosts;
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative;
- A hybrid contract is not measured at fair value with changes in fair value recognized in the profit or loss (i.e., derivatives that are embedded in a financial liability at fair value through profit or loss are not separated as the entire contract is fair valued).

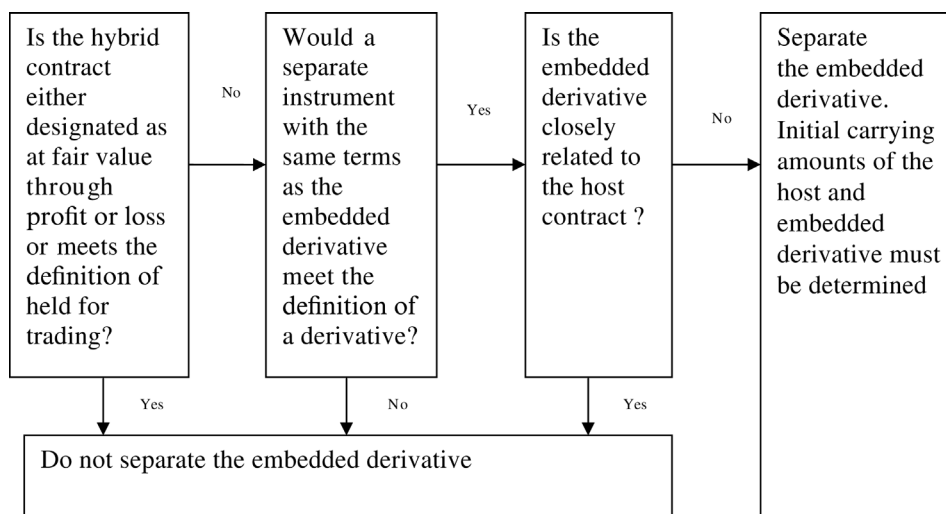
An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative. If the bond is classified as available-for-sale with fair value changes

recognized in other comprehensive income until the bond is sold, the equity conversion option (the embedded derivative) is generally separated. The amount paid for the bond is split between the debt security without the conversion option and the equity conversion option itself. Changes in the fair value of the equity conversion option are recognized in profit or loss unless the option is part of a cash flow hedging relationship. If the convertible bond is carried at fair value with changes in fair value reported in profit or loss, separating the embedded derivative from the host bond is not permitted.

The closely related condition above is generally the most difficult one to assess. This is because IAS 39 does not define what is closely related. It is therefore necessary for the entity to exercise judgement with reference to this criterion.

Under IFRIC 9, the assessment of whether an embedded derivative is closely related is made when the entity first becomes party to the contract and that the entity is prohibited from reassessing the closely related conclusions initially drawn in subsequent periods. However, this reassessment is required where there is a significant change to the contract that modifies the cash flows that would be otherwise required under the original contract. Reassessment is also required when the entity reclassifies the complete contract out of the FVTPL category.

When an evaluation made using the criteria in IAS 39 leads to a conclusion that the embedded derivative must be separately accounted for, the initial carrying amounts of a host and the embedded derivative must be determined. Since the embedded derivative must be recorded at fair value with changes in fair value reported in profit or loss, the initial carrying amount assigned to the host contract on separation is determined as the difference between the cost (i.e., the fair value of the consideration given) for the hybrid (combined) instrument and the fair value of the embedded derivative.



Debt instruments commonly include interest rate caps and floors. An interest rate cap where not leveraged is always closely related to the debt host contract where the cap is at or above the market interest rate at inception. Likewise, a non-leveraged floor is always closely related when it is at or below the market interest rate at inception. As mentioned above, this assessment is made at inception of the contract/initial recognition and is not subsequently reassessed even where market interest rates were to change such that the caps/floors were to become effective.

IAS 32 requires that in separating the liability and equity components contained in a compound financial instrument, the issuer must first allocate fair value to the liability component, leaving only the residual (the difference between aggregate fair value and that allocated to liabilities) to be assigned to the equity component. However, IAS 32 is not applicable to the separation of a derivative from a hybrid instrument under IAS 39. It would be inappropriate to allocate the basis in the hybrid instrument under IAS 39 to the derivative and non-derivative components based on their relative fair values, since that might result in an immediate gain or loss being recognized in profit or loss on the subsequent measurement of the derivative at fair value.

#### **Example of separate contracts that cannot be deemed an embedded derivative**

Erehwon AG acquires a five-year floating-rate debt instrument issued by Spacemaker Co. At the same time, it enters into a five-year “pay-variable, receive-fixed” interest rate swap with the St. Helena Bank. Erehwon argues that the combination of the debt instrument and swap is a “synthetic fixed-rate instrument” and accordingly classifies the instrument as a held-to-maturity investment, since it has the positive intent and ability to hold it to maturity. Erehwon contends that separate accounting for the swap is inappropriate, since IAS 39 requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract.

The company’s analysis is not correct. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument (synthetic instrument accounting) for the purposes of applying IAS 39. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately.

#### **Example**

A five-year debt instrument has fixed annual payments and a principal repayment at the end of the contract based on the changes in the NSE 100 index. This would not be classified as a floating rate debt with an embedded equity swap that has an offsetting floating rate leg. This instead would be a debt host fixed-rate contract.

Determination of debt or equity host contract is simple to differentiate. Many times the host will behave more like either debt or equity for easier determination. If the host contract has no stated maturity date and remains with a residual interest that is in the favour of the issuer, it is more likely to be an equity contract based on the conditions of the economic characteristics and risks.

Multiple embedded derivatives: IAS 39 AG 29 requires that where a host contract includes more than one embedded derivative, unless the individual derivatives relate to different risk exposures and are readily separable from each other, the multiple derivatives are generally treated as a single compound embedded derivative. However, in making this determination as a first step each embedded derivative is individually assessed to see if it is closely related. Only those that are not closely related are taken to the next step of determining whether they relate to different risks or whether in combination they represent a single compound derivative.

#### **Example**

ABC Corp. issues a debt instrument which contains a prepayment/early redemption offer as well as an interest rate cap. It will be important to first consider whether, individually, the interest rate cap and the early payment option are closely related. If the instrument carries an interest rate

of LIBOR + 2% with a cap of 6% and on issue date LIBOR is at 4.5% this means that the cap is effective and therefore in the money. In this case the cap is not closely related and therefore meets the conditions of an embedded derivative that needs to be separately accounted for. The prepayment option permits ABC to early repay the instrument at a value of \$110 compared to the issue price of \$100. The entity uses a 5% threshold to determine whether the option is closely related. In this case the prepayment option is also not closely related. Having determined this, the next step would be for the entity to determine whether both the individual embedded derivatives relate to similar risk exposures; which in this case they probably do as they relate to interest rate risks. They would therefore be accounted for as a single separated embedded derivative.

If on the other hand the cap was at 8% (i.e. out of the money) and the prepayment option was at \$104, both embedded derivatives would be determined to be individually closely related and therefore separation would not be required for either, whether individually or in combination.

### **Hedging Accounting under IAS 39**

When there is a hedging relationship between a hedging instrument and another item (the underlying), and certain conditions are met, then “hedge accounting” under IAS 39 can be applied.

Hedge accounting is a method or presentation in the financial statements. The objective of such presentation is to achieve matching between the gain or loss that arises on a hedging instrument. IAS 39 does not mandate the use of hedge accounting and it is therefore voluntary.

Hedging instruments are often financial derivatives, such as forwards, options, swaps or futures, but this is not a necessary condition. Hedging may be engaged in to protect against changes in fair values, changes in expected cash flows, or changes in the value of an investment in a foreign operation, such as a subsidiary, due to currency rate movements.

A fair value hedge is a hedge of the exposure to changes in fair values of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributed to a particular risk and could affect profit or loss.

A cash flow hedge is a hedge of the exposure to variability in cash flows that are attributed to a particular risk associated with a recognized asset or liability or a highly probable forecast transaction which could affect profit or loss.

IAS 39 defines a firm commitment as a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. Where an entity hedges against such firm commitments, these are normally fair value hedges, with the exception of hedging against foreign currency risk where IAS 39 provides alternatives for accounting for this either as a fair value or cash flow hedge.

A forecast transaction is an uncommitted but anticipated future transaction. Forecast transactions can only be cash flow hedged provided that the transaction is considered to be highly probable.

For a simplistic example of the need for, and means of, hedging, consider an entity that holds US Treasury bonds as an investment. The bonds have a maturity some 10 years in the future, but the entity actually intends to dispose of these in the intermediate term, for example, within four years to partially finance a plant expansion currently being planned. Obviously, an unexpected increase in general interest rates during the projected four-year holding period would be an unwelcome development, since it would cause a decline in the market value of the bonds and could accordingly result in an unanticipated loss of principal.

One means of guarding against this would be to purchase a put option on these bonds, permitting the entity to sell them at an agreed-upon price, which would be most valuable should there be a price decline. If interest rates do indeed rise, the increasing value of the “put” will (if properly structured) offset the declining value of the bonds themselves, thus providing an effective fair value hedge. (Other hedging strategies are also available, including selling short Treasury bond futures, and the entity of course could have reduced or eliminated the need to hedge entirely by having invested in Treasury bonds having a maturity more closely matched to its anticipated cash need.)

Hedge accounting is necessitated by the fact that fair value changes in not all financial instruments are reported in current profit or loss. Thus, if the entity in the foregoing example holding the Treasury bonds has elected to report changes in available-for-sale investments (which would include the Treasury bonds in this instance) in other comprehensive income, but the changes in the fair value of the hedging instrument (the put option) were to be reported in profit or loss, there would be a fundamental mismatching which would distort the real hedging relationship that had been established. To avoid this result, the entity may elect to apply hedge accounting as prescribed by IAS 39. It should be noted, though, that hedge accounting is optional. An entity that carries out hedging activities for risk management purposes may well decide not to apply hedge accounting for some hedging transactions if it wishes to reduce the cost and burden of complying with the hedge accounting requirements in IAS 39.

IAS 39 permits hedge accounting provided that the entity specifically designates as a hedge the hedging instrument and the hedged item at the inception of the hedge accounting intended point. Critically, IAS 39 requires that formal documentation of the intention to apply hedge accounting must be prepared prospectively (“hedge documentation”). An entity cannot retrospectively decide to apply hedge accounting. In considering documentation requirements, important aspects under IAS 39 are that:

- Hedge accounting must be consistent with the entity’s established risk management framework/strategy;
- The hedge documentation must identify the hedging instrument;
- The hedge documentation must identify the hedged item or the transaction and the nature of risk being hedged; and
- The hedge documentation must specify how “effectiveness” of the hedge will be assessed and how any ineffectiveness will be measured.

#### *Accounting for gains and losses from fair value hedges*

The accounting for qualifying gains and losses on fair value hedges is as follows:

1. On the hedging instrument, they are recognized in profit or loss.
2. On the hedged item, they are recognized in profit or loss even if the gains or losses would normally have been recognized in other comprehensive income if not hedged.

The foregoing rule applies even in the case of investments (classified as available-for-sale) for which unrealized gains and losses are being recognized in other comprehensive income, if that method was appropriately elected by the reporting entity, as permitted by IAS 39. In all instances, to the extent that there are differences between the amounts of gain or loss on hedging and hedged items, these will be due either to amounts excluded from assessment effectiveness, or to hedge ineffectiveness; in either event, these are recognized currently in profit or loss.

As an example, consider an available-for-sale (AFS) financial asset, the carrying amount of which is adjusted by the amount of gain or loss resulting from the hedged risk, a fair value hedge. It is assumed that the entire investment was hedged, but it is also possible to hedge merely a portion of the investment. The facts are as follows:

Hedged item:	Available-for-sale financial asset
Hedging instrument:	Put option
Underlying:	Price of the security
Notional amount:	100 shares of the financial asset

### Example 1

On July 1, 20XX, Gardiner Company purchased 100 shares of Dizzy Co. ordinary shares at €15 per share and classified it as an available-for-sale financial asset. On October 1, Gardiner Company purchased an at-the-money put on Dizzy with an exercise price of €25 and an expiration date of April 20XX+1. This put purchase locks in a profit of €650, as long as the price is equal to €25 or lower, but allows continued profitability if the price of the Dizzy share goes above €25. (In other words, the put cost a premium of €350, which if deducted from the locked-in gain [= €2,500 market value less €1,500 cost] leaves a net gain of €650 to be realized.)

The premium paid for an at-the-money option (i.e., where the exercise price is current fair value of the underlying) is the price paid for the right to have the entire remaining option period in which to exercise the option. In the present example, Gardiner Company specifies that only the intrinsic value of the option is to be used to measure effectiveness. Thus, the time value decreases of the put will be charged against profit or loss of the period, and not offset against the change in value of the underlying, hedged item. Gardiner Company then documents the hedge's strategy, objectives, hedging relationships and method of measuring effectiveness. The following table shows the fair value of the hedged item and the hedging instrument.

	<b>Case One</b>			
	<u>10/1/XX</u>	<u>12/31/XX</u>	<u>3/31/XX+1</u>	<u>4/17/XX+1</u>
<b>Hedged item:</b>				
Dizzy share price	€ 25	€ 22	€ 20	€ 20
Number of shares	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
Total value of shares	<u>€2,500</u>	<u>€2,200</u>	<u>€2,000</u>	<u>€2,000</u>
<b>Hedging instrument:</b>				
Put option (100 shares)				
Intrinsic value	€ 0	€ 300	€ 500	€ 500
Time value	<u>350</u>	<u>215</u>	<u>53</u>	<u>0</u>
Total	<u>€ 350</u>	<u>€ 515</u>	<u>€ 553</u>	<u>€ 500</u>
Intrinsic value	<u>€ 0</u>	<u>€ 300</u>	<u>€ 200</u>	<u>€ 0</u>
Gain (loss) on put from last measurement date				

Entries to record the foregoing changes in value, ignoring tax effects and transaction costs, are as follows:

7/1/XX	Purchase:	Available-for-sale investment	1,500	
		Cash		1,500
9/30/XX	End of quarter:	Valuation allowance—available-for-sale investment	1,000	
		Other comprehensive income		1,000

10/1/XX	Put purchase:	Put option	350	
		Cash		350
12/31/XX	End of year:	Put option	300	
		Hedge gain/loss (intrinsic value gain)		300
		Gain/loss	162	
		Put option (time value loss)		162
		Hedge gain/loss	300	
		Available-for-sale investment (market value loss)		300
3/31/XX+1	End of quarter:	Put option	200	
		Hedge gain/loss (intrinsic value changes)		200
		Gain/loss	162	
		Put option (time value loss)		162
		Hedge gain/loss	200	
		Available-for-sale investment (market value loss)		200
4/17/XX+1	Put expires:	Put option	0	
		Hedge gain/loss (intrinsic value changes)		0
		Gain/loss	53	
		Put option (time value changes)		53
		Hedge gain/loss	0	
		Available-for-sale investment (market value changes)		0

An option is said to be “in-the-money” if the exercise price is above the market value (for a put option) or below the market value (for a call option). At or before expiration, an in-the-money put should be sold or exercised (to let it simply expire would be to effectively discard a valuable asset). It should be stressed that this applies to so-called “American options,” which may be exercised at any time prior to expiration; so-called “European options” can only be exercised at the expiration date. Assuming that the put option is sold immediately before its expiration date, the entry would be:

4/17/XX+1	Put sold:	Cash	500	
		Put option		500

On the other hand, if the put is exercised (i.e., the underlying instrument is delivered to the counterparty, which is obligated to pay €25 per share), the entry would be:

4/17/XX+1	Cash	2,500	
	Other comprehensive income	1,000	
	Valuation allowance—available-for-sale investment		1,000
	Available-for-sale investment		1,000
	Put option		500
	Gain on sale of investment		1,000

The cumulative effect on retained earnings of the hedge and sale is a net gain of €650 (= €1,000 – €350).

**Example 2**

To further illustrate fair value hedge accounting, the facts in the preceding example will now be slightly modified. Now, the share price increases after the put option is purchased, thus making the put worthless, since the shares could be sold for a more advantageous price on the open market.

	<b>Case Two</b>			
	<u>10/1/ XX</u>	<u>12/31/ XX</u>	<u>3/31/ XX+1</u>	<u>4/17/ XX+1</u>
<b>Hedged item:</b>				
Dizzy share price	€ 25	€ 28	€ 30	€ 31
Number of shares	100	100	100	100
Total value of shares	<u>€ 2,500</u>	<u>€ 2,800</u>	<u>€ 3,000</u>	<u>€ 3,100</u>
	<u>10/1/13</u>	<u>12/31/13</u>	<u>3/31/14</u>	<u>4/17/14</u>
<b>Hedging instrument:</b>				
Put option (100 shares)				
Intrinsic value	€ 0	€ 0	€ 0	€ 0
Time value	350	100	25	0
Total	<u>€ 350</u>	<u>€ 100</u>	<u>€ 25</u>	<u>€ 0</u>
<b>Intrinsic value</b>				
Gain (loss) on put from last measurement date	<u>€ 0</u>	<u>€ 0</u>	<u>€ 0</u>	<u>€ 0</u>

Entries to record the foregoing changes in value, ignoring tax effects and transaction costs, are as follows:

7/1/XX	Purchase:	Available-for-sale investment	1,500	
		Cash		1,500
9/30/XX	End of quarter:	Valuation allowance—available-for-sale investment	1,000	
		Other comprehensive income		1,000
10/1/XX	Put purchase:	Put option	350	
		Cash		350
12/31/XX	End of year:	Put option	0	
		Hedge gain/loss (intrinsic value gain)		0
		Hedge gain/loss	250	
		Put option (time value loss)		250
		Available-for-sale investment	300	
		Other comprehensive income		300
3/31/XX+1	End of quarter:	Put option	0	
		Hedge gain/loss (intrinsic value change)		0
		Hedge gain/loss	75	
		Put option (time value loss)		75
		Available-for-sale investment	200	
		Other comprehensive income		200
4/17/XX+1	Put expires:	Put option	0	
		Hedge gain/loss (intrinsic value change)		0
		Hedge gain/loss	25	
		Put option (time value change)		25
		Available-for-sale investment	100	
		Other comprehensive income		100



The put expired unexercised and Gardiner Company must decide whether to sell the investment. If it continues to hold, normal IAS 39 accounting would apply. In this example, since it was hypothesized that Gardiner had elected to record the effects of value changes (apart from those which were hedging related) in other comprehensive income, it would continue to apply this accounting after the expiration of the put option. Assuming, however, that the investment is instead sold, the entry would be:

4/17/XX+1	Cash	3,100	
	Other comprehensive income	1,600	
	Available-for-sale investment		1,500
	Valuation allowance—available-for-sale investment		1,600
	Gain on sale of investment		1,600

### ***Discontinuance of fair value hedge accounting***

An entity must prospectively discontinue hedge accounting if:

- The hedging instrument expires or is sold, terminated or exercised. However, note that rollover on expiration of a hedging instrument may not amount to termination. The IASB also in its amendments to IAS 39, *Novations of Derivatives and Continuation of Hedge Accounting* clarified where hedging instruments are novated to different counterparties (e.g., transfer of OTC arrangements to central counterparties as required by recent legislation in several jurisdictions). The amendment provides that hedge accounting need not be discontinued arising only out of such novation;
- The hedge no longer meets the hedge accounting criteria, e.g., is no longer highly effective; or
- The entity optionally elects to discontinue the hedge relationship. Note that the entity could still prospectively designate a new relationship as a hedge.

**Accounting for gains and losses from cash flow hedges.** Cash flow hedges generally involve forecasted transactions or events. The intention is to defer the recognition of gains or losses arising from the hedging activity itself until the forecasted transaction takes place, and then to have the formerly deferred gain or loss affect profit or loss when the forecasted transaction affects profit or loss. While overwhelmingly it will be derivative financial instruments that are used to hedge cash flows relating to forecasted transactions, IAS 39 contemplates the use of non-derivatives for this purpose as well in the case of hedges of foreign currency risk. Forecasted transactions may include future cash flows arising from presently existing, recognized assets or liabilities—for example, future interest rate payments to be made on debt carrying floating interest rates are subject to cash flow hedging.

The accounting for qualifying gains and losses on cash flow hedges is as follows:

1. On the hedging instrument, the portion of the gain or loss that is determined to be an effective hedge will be recognized in other comprehensive income.
2. Also on the hedging instrument, the ineffective portion should be reported in profit or loss, if the instrument is a derivative; otherwise, it should be reported in a manner consistent with the accounting for other financial assets or liabilities as set forth in IAS 39. Thus, if an available-for-sale financial asset has been used as the hedging instrument in a particular cash flow hedging situation, and the entity has elected to

report value changes in other comprehensive income, then any ineffective portion of the hedge should continue to be recorded in other comprehensive income.

The amounts recognized in other comprehensive income should be included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss. Accordingly, when the forecasted transactions occur, the amounts previously recognized in other comprehensive income are reclassified from equity to profit or loss. For instance, if an interest rate swap is designated as a hedging instrument of a series of forecasted cash flows, the changes in the cash flows of the swap are recognized in net profit or loss in the periods when the forecasted cash flows and the cash flows of the swap offset each other.

According to IAS 39, the separate component of equity associated with the hedged item should be adjusted to the lesser (in absolute terms) of either the cumulative gain or loss on the hedging instrument necessary to offset the cumulative change in expected future cash flows on the hedged item from hedge inception, excluding the ineffective portion, or the fair value of the cumulative change in expected future cash flows on the hedged item from inception of the hedge. Furthermore, any remaining gain or loss on the hedging instrument (i.e., the ineffective portion) must be recognized currently in profit or loss or in other comprehensive income, as dictated by the nature of the instrument and entity's accounting policy (for available-for-sale instruments, where there is a choice of reporting in other comprehensive income or in profit or loss). If the entity's policy regarding the hedge is to exclude a portion from the measure of hedge effectiveness (e.g., time value of options in the preceding example in this section), then any related gain or loss must be recognized in either profit or loss or other comprehensive income based on the nature of the item and the elected policy.

IAS 39 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, IAS 39 does not preclude redesignating the hedging instrument. The standard indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity but does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognized immediately in net profit or loss and hedge accounting based on the previous designation of the hedge relationship cannot be continued. In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship, provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

IAS 39 permits a portion of a cash flow exposure to be designated as a hedged item. While IAS 39 does not specifically address a hedge of a portion of a cash flow exposure for a forecasted transaction, it specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecasted reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness.

Basis adjustment—where a forecast transaction subsequently culminates in the recognition of a non-financial asset or liability (e.g., inventory) the entity has an accounting policy choice under IAS 39 to either:

- Reclassify the gains and losses in OCI from equity to profit or loss in the same period when the acquired asset or liability affects profit or loss; or
- Reclassify the gains and losses in OCI to the initial carrying amount of the non-financial asset or liability when it is recognized.

The selected policy must be consistently applied to all similar hedges. If a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecasted interest cash flows or portions thereof on a gross basis, there will be no basis adjustment when the forecasted cash flow occurs. There is no basis adjustment because the hedged forecasted transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognized in net profit or loss in the period in which the forecasted transactions occur. Although the types of hedges described herein would not result in basis adjustment if instead the derivative is designated as a hedge of a forecasted purchase of a financial asset or issuance of a liability, the derivative gain or loss would be an adjustment to the basis of the asset or liability upon the occurrence of the transaction.

#### Example of “plain vanilla” interest rate swap

On July 1, 20XX, Abbott Corp. borrows €5 million with a fixed maturity (no prepayment option) of June 30, 20XX+4, carrying interest at the US prime interest rate + 1/2%. Interest payments are due semi-annually; the entire principal is due at maturity. At the same date, Abbott Corp. enters into a “plain-vanilla-type” swap arrangement, calling for fixed payments at 8% and the receipt of prime + 1/2%, on a notional amount of €5 million. At that date prime is 7.5%, and there is no premium due on the swap arrangement since the fixed and variable payments are equal. (Note that swaps are privately negotiated and, accordingly, a wide range of terms will be encountered in practice; this is simply intended as an example, albeit a very typical one.)

The foregoing swap qualifies as a cash flow hedge under IAS 39. Given the nature of this swap, it is reasonable to assume no ineffectiveness, but in real world situations this must be carefully evaluated with reference to the specific circumstances of each case; IAS 39 does not provide a short-cut method (which contrasts with the corresponding US GAAP standard). IAS 39 defines effectiveness in terms of results: if at inception and throughout the life of the hedge, the entity can expect an almost complete offset of cash flow variations, and in fact (retrospectively) actual results are within a range of 80 to 125%, the hedge will be judged highly effective.

In the present example, assume that in fact the hedge proves to be highly effective. Also, assume that the prime rate over the four-year term of the loan, as of each interest payment date, is as follows, along with the fair value of the remaining term of the interest swap at those dates:

<u>Date</u>	<u>Prime rate (%)</u>	<u>Fair value of swap*</u>
December 31, 20XX	6.5	€(150,051)
June 30, 20XX+1	6.0	(196,580)
December 31, 20XX+1	6.5	(111,296)
June 30, 20XX+2	7.0	(45,374)

December 31, 20XX+2	7.5	0
June 30, 20XX+3	8.0	23,576
December 31, 20XX+3	8.5	24,038
June 30, 20XX+4	8.0	0

\*Fair values are determined as the present values of future cash flows resulting from expected interest rate differentials, based on current prime rate, discounted at 8%.

Regarding the fair values presented in the foregoing table, it should be assumed that the fair values of the swap contract are precisely equal to the present value, at each valuation date (assumed to be the interest payment dates), of the differential future cash flows resulting from utilization of the swap. Future variable interest rates (prime + 1/2%) are assumed to be the same as the existing rates at each valuation date (i.e., the yield curve is flat and there is no basis for any expectation of rate changes, and therefore, the best estimate at any given moment is that the current rate will persist over time). The discount rate, 8%, is assumed to be constant over time.

Thus, for example, the fair value of the swap at December 31, 20XX, would be the present value of an annuity of seven payments (the number of remaining semi-annual interest payments due) of €25,000 each (pay 8%, receive 7%, based on then-existing prime rate of 6.5%) to be made to the swap counterparty, discounted at an annual rate of 8%. (Consistent with the convention for quoting interest rates as bond-equivalent yields, 4% is used for the semi-annual discounting, rather than the rate that would compound to 8% annually.) The present value of a stream of seven €25,000 payments to the swap counterparty amounts to €150,051 at December 31, 20XX, which is the swap liability to be reported by Abbott Corp. at that date. The offset is a debit to other comprehensive income, since the hedge is continually judged to be 100% effective in this case.

The semi-annual accounting entries will be as follows:

#### December 31, 20XX

Interest expense	175,000	
Accrued interest (or cash)		175,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (7.0%)</i>		
Interest expense	25,000	
Accrued interest (or cash)		25,000
<i>To record net settle-up on swap arrangement [8.0 – 7.0%]</i>		
Other comprehensive income	150,051	
Obligation under swap contract		150,051
<i>To record the fair value of the swap contract as of this date (a net liability because fixed rate payable is below expected variable rate based on current prime rate)</i>		

#### June 30, 20XX+1

Interest expense	162,500	
Accrued interest (or cash)		162,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (6.5%)</i>		
Interest expense	37,500	
Accrued interest (or cash)		37,500
<i>To record net settle-up on swap arrangement [8.0 – 6.5%]</i>		
Other comprehensive income	46,529	
Obligation under swap contract		46,529
<i>To record the fair value of the swap contract as of this date (increase in obligation because of further decline in prime rate)</i>		

**December 31, 20XX+1**

Interest expense	175,000	
Accrued interest (or cash)		175,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (7.0%)</i>		
Interest expense	25,000	
Accrued interest (or cash)		25,000
<i>To record net settle-up on swap arrangement [8.0 – 7.0%]</i>		
Obligation under swap contract	85,284	
Other comprehensive income		85,284
<i>To record the fair value of the swap contract as of this date (decrease in obligation due to increase in prime rate)</i>		

**June 30, 20XX+2**

Interest expense	187,500	
Accrued interest (or cash)		187,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (7.5%)</i>		
Interest expense	12,500	
Accrued interest (or cash)		12,500
<i>To record net settle-up on swap arrangement [8.0 – 7.5%]</i>		
Obligation under swap contract	65,922	
Other comprehensive income		65,922
<i>To record the fair value of the swap contract as of this date (further increase in prime rate reduces fair value of derivative)</i>		

**December 31, 20XX+2**

Interest expense	200,000	
Accrued interest (or cash)		200,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (8.0%)</i>		
Interest expense	0	
Accrued interest (or cash)		0
<i>To record net settle-up on swap arrangement [8.0 – 8.0%]</i>		
Obligation under swap contract	45,374	
Other comprehensive income		45,374
<i>To record the fair value of the swap contract as of this date (further increase in prime rate eliminates fair value of the derivative)</i>		

**June 30, 20XX+3**

Interest expense	212,500	
Accrued interest (or cash)		212,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (8.5%)</i>		
Accrued interest (or cash)	12,500	
Interest expense		12,500
<i>To record net settle-up on swap arrangement [8.0 – 8.5%]</i>		
Receivable under swap contract	23,576	
Other comprehensive income		23,576
<i>To record the fair value of the swap contract as of this date (increase in prime rate creates net asset position for derivative)</i>		

**December 31, 20XX+3**

Interest expense	225,000	
Accrued interest (or cash)		225,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (9.0%)</i>		

Accrued interest (or cash)	25,000	
Interest expense		25,000
<i>To record net settle-up on swap arrangement [8.0 – 9.0%]</i>		
Receivable under swap contract	462	
Other comprehensive income		462
<i>To record the fair value of the swap contract as of this date (increase in asset value due to further rise in prime rate)</i>		
<b>June 30, 20XX+4</b>		
Interest expense	212,500	
Accrued interest (or cash)		212,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (8.5%)</i>		
Accrued interest (or cash)	12,500	
Interest expense		12,500
<i>To record net settle-up on swap arrangement [8.0 – 8.5%]</i>		
Other comprehensive income	24,038	
Receivable under swap contract		24,038
<i>To record the fair value of the swap contract as of this date (value declines to zero as expiration date approaches)</i>		

#### Example of option on an interest rate swap

The facts of this example are a further variation on the previous one (the “plain vanilla” swap). Abbott Corp. anticipates that as of June 30, 20XX+2, it will become a borrower of €5 million with a fixed maturity four years hence (i.e., at June 30, 20XX+6). Based on its current credit rating, it will be able to borrow at the US prime interest rate + 1/2%. As of June 30, 20XX, it is able to purchase a “swaption” (an option on an interest rate swap, calling for fixed pay at 8% and variable receipt at prime + 1/2%, on a notional amount of €5 million, for a term of four years) for a single payment of €25,000. The option will expire in two years. At June 30, 20XX, the prime is 7.5%.

*NOTE: The interest rate behaviour in this example differs somewhat from the prior example, to better illustrate the “one-sidedness” of options, versus the obligation under a plain vanilla swap arrangement or of other non-option contracts, such as futures and forwards.*

It will be assumed that the time value of the swaption expires rateably over the two years.

This swaption qualifies as a cash flow hedge under IAS 39. However, while the change in fair value of the contract is an effective hedge of the cash flow variability of the prospective debt issuance, the premium paid is a reflection of the time value of money and would not be an effective part of the hedge. Accordingly, it is to be expensed as incurred, rather than being deferred.

The table below gives the prime rate at semi-annual intervals including the two-year period prior to the debt issuance, plus the four years during which the debt (and the swap, if the option is exercised) will be outstanding, as well as the fair value of the swaption (and later, the swap itself) at these points in time.

<u>Date</u>	<u>Prime rate (%)</u>	<u>Fair value of swaption/swap*</u>
December 31, 20XX	7.5	€ 0
June 30, 20XX+1	8.0	77,925
December 31, 20XX+1	6.5	0
June 30, 20XX+2	7.0	(84,159)
December 31, 20XX+2	7.5	0
June 30, 20XX+3	8.0	65,527
December 31, 20XX+3	8.5	111,296

June 30, 20XX+4	8.0	45,374
December 31, 20XX+4	8.0	34,689
June 30, 20XX+5	7.5	0
December 31, 20XX+5	7.5	0
June 30, 20XX+6	7.0	0

\* Fair value is determined as the present value of future expected interest rate differentials, based on current prime rate, discounted at 8%. An “out-of-the-money” swaption is valued at zero, since the option does not have to be exercised. Since the option is exercised on June 30, 20XX, the value at that date is recorded, although negative.

The value of the swaption contract is only recorded (unless and until exercised, of course, at which point it becomes a contractually binding swap) if it is positive, since if “out-of-the-money,” the holder would forego exercise in most instances and thus there is no liability by the holder to be reported. This illustrates the asymmetrical nature of options, where the most that can be lost by the option holder is the premium paid, since exercise by the holder is never required, unlike the case with futures and forwards, in which both parties are obligated to perform.

The present example is an illustration of counterintuitive (but not really illogical) behaviour by the holder of an out-of-the-money option. Despite having a negative value, the option holder determines that exercise is advisable, presumably because it expects that over the term of the debt unfavourable movements in interest rates will occur.

At June 30, 20XX, the swaption is an asset, since the reference variable rate (prime + 1/2%) is greater than the fixed swap rate, and thus the expectation is that the option will be exercised at expiration. This would (if present rates hold steady, which is the naive assumption) result in a series of eight semi-annual payments from the swap counterparty in the amount of €12,500. Discounting this at a nominal 8%, the present value as of the debt origination date (to be June 30, 20XX+2) would be €84,159, which, when further discounted to June 30, 20XX+1, yields a fair value of €77,925.

Note that the following period (at December 31, 20XX+1) prime drops to such an extent that the value of the swaption evaporates entirely. Actually, the value becomes negative, which will not be reported since the holder is under no obligation to exercise the option under unfavourable conditions; the carrying value is therefore eliminated as of that date.

At the expiration of the swaption contract, the holder does (for this example) exercise, notwithstanding a negative fair value, and from that point forward the fair value of the swap will be reported, whether positive (an asset) or negative (a liability). Once exercised, the swap represents a series of forward contracts, the fair value of which must be fully recognized under IAS 39. (Note that, in the real world, the holder would have likely had another choice: to let the unfavourable swaption expire unexercised, but to negotiate a new interest rate swap, presumably at more favourable terms given that prime is only 7% at that date; for example, a swap of 7.5% fixed versus prime + 1/2% would likely be available at little or no cost.)

As noted above, assume that, at the option expiration date, despite the fact that prime + 1/2% is below the fixed pay rate on the swap, the management is convinced that rates will climb over the four-year term of the loan, and thus it does exercise the swaption at that date. Given this, the accounting journal entries over the entire six years are as follows:

**June 30, 20XX**

Swaption contract	25,000	
Cash		25,000

*To record purchase premium on swaption contract*

**December 31, 20XX**

Gain/loss on hedging arrangement	6,250	
Swaption contract		6,250

*To record change in time value of swaption contract—charge premium to income since this represents payment for time value of money, which expires rateably over two-year term*

**June 30, 20XX+1**

Swaption contract	77,925	
Other comprehensive income		77,925

*To record the fair value of the swaption contract as of this date*

Gain/loss on hedging arrangement	6,250	
Swaption contract		6,250

*To record change in time value of swaption contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term*

**December 31, 20XX+1**

Other comprehensive income	77,925	
Swaption contract		77,925

*To record the change in fair value of the swaption contract as of this date; since contract is out-of-the-money, it is not written down below zero (i.e., a net liability is not reported)*

Gain/loss on hedging arrangement	6,250	
Swaption contract		6,250

*To record change in time value of swaption contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term*

**June 30, 20XX+2**

Other comprehensive income	84,159	
Swaption contract		84,159

*To record the fair value of the swaption contract as of this date—a net liability is reported since swap option was exercised*

Gain/loss on hedging arrangement	6,250	
Swaption contract		6,250

*To record change in time value of swaption contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term*

**December 31, 20XX+2**

Interest expense	200,000	
Accrued interest (or cash)		200,000

*To accrue or pay interest on the debt at the variable rate of prime + 112% (8.0%)*

Interest expense	0	
Accrued interest (or cash)		0

*To record net settle-up on swap arrangement [8.0 – 8.0%]*

Swap contract	84,159	
Other comprehensive income		84,159

*To record the change in the fair value of the swap contract as of this date*

**June 30, 20XX+3**

Interest expense	212,500	
Accrued interest (or cash)		212,500

*To accrue or pay interest on the debt at the variable rate of prime + 112% (8.5%)*

Accrued interest (or cash)	12,500	
Interest expense		12,500

*To record net settle-up on swap arrangement [8.0 – 8.5%]*



Swap contract	65,527	
Other comprehensive income		65,527
<i>To record the fair value of the swap contract as of this date</i>		
<b>December 31, 20XX+3</b>		
Interest expense	225,000	
Accrued interest (or cash)		225,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (9.0%)</i>		
Accrued interest (or cash)	25,000	
Interest expense		25,000
<i>To record net settle-up on swap arrangement [8.0 – 9.0%]</i>		
Swap contract	45,769	
Other comprehensive income		45,769
<i>To record the fair value of the swap contract as of this date</i>		
<b>June 30, 20XX+4</b>		
Interest expense	212,500	
Accrued interest (or cash)		212,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (8.5%)</i>		
Accrued interest (cash)	12,500	
Interest expense		12,500
<i>To record net settle-up on swap arrangement [8.0 – 8.5%]</i>		
Other comprehensive income	65,922	
Swap contract		65,922
<i>To record the change in the fair value of the swap contract as of this date (declining prime rate causes swap to lose value)</i>		
<b>December 31, 20XX+4</b>		
Interest expense	212,500	
Accrued interest (or cash)		212,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (8.5%)</i>		
Accrued interest (or cash)	12,500	
Interest expense		12,500
<i>To record net settle-up on swap arrangement [8.0 – 8.5%]</i>		
Other comprehensive income	10,685	
Swap contract		10,685
<i>To record the fair value of the swap contract as of this date (decline is due to passage of time, as the prime rate expectations have not changed from the earlier period)</i>		
<b>June 30, 20XX+5</b>		
Interest expense	200,000	
Accrued interest (or cash)		200,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 1/2% (8.0%)</i>		
Accrued interest (or cash)	0	
Interest expense		0
<i>To record net settle-up on swap arrangement [8.0 – 8.5%]</i>		
Other comprehensive income	34,689	
Swap contract		34,689
<i>To record the fair value of the swap contract as of this date</i>		

**December 31, 20XX+5**

Interest expense	200,000	
Accrued interest (or cash)		200,000
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (8.0%)</i>		
Accrued interest (or cash)	0	
Interest expense	0	
<i>To record net settle-up on swap arrangement [8.0 – 8.0%]</i>		
Swap contract	0	
Other comprehensive income	0	
<i>No change to the fair value of the swap contract as of this date</i>		

**June 30, 20XX+6**

Interest expense	187,500	
Accrued interest (or cash)		187,500
<i>To accrue or pay interest on the debt at the variable rate of prime + 112% (7.5%)</i>		
Interest expense	12,500	
Accrued interest (or cash)		12,500
<i>To record net settle-up on swap arrangement [8.0 – 7.5%]</i>		
Other comprehensive income	0	
Swap contract		0
<i>No change to the fair value of the swap contract, which expires as of this date.</i>		

**Example of using options to hedge a future purchase of inventory**

Friendly Chemicals Corp. uses petroleum as a feedstock from which it produces a range of chemicals for sale to producers of synthetic fabrics and other consumer goods. It is concerned about the rising price of oil and decides to hedge a major purchase it plans to make in mid-20XX. Oil futures and options are traded on the New York Mercantile Exchange and in other markets; Friendly decides to use options rather than futures because it is only interested in protecting itself from a price increase; if prices decline, it wishes to reap that benefit rather than suffer the loss which would result from holding a futures contract in a declining market environment.

At December 31, 20XX+1, Friendly projects a need for 10 million barrels of crude oil of a defined grade to be purchased by mid-20XX+2; this will suffice for production through mid-20XX+2. The current world price for this grade of crude is €64.50 per barrel, but prices have been rising recently. Management desires to limit its crude oil costs to no higher than €65.75 per barrel, and accordingly purchases, at a cost of €2 million, an option to purchase up to 10 million barrels at a cost of €65.55 per barrel, at any time through December 20XX+2. When the option premium is added to this €65.55 per barrel cost, it would make the total cost €65.75 per barrel if the full 10 million barrels are acquired.

Management has studied the behaviour of option prices and has concluded that changes in option prices that relate to time value are not correlated to price changes and hence are ineffective in hedging price changes. On the other hand, changes in option prices that pertain to pricing changes (intrinsic value changes) are highly effective as hedging vehicles. The table below reports the value of these options, analysed in terms of time value and intrinsic value, over the period from December 20XX through December 20XX+2.

<u>Date</u>	<u>Price of oil/barrel</u>	<u>Fair value of option relating to</u>	
		<u>Time value</u> *	<u>Intrinsic value</u>
December 31, 20XX+1	€64.50	€2,000,000	€ 0
January 31, 20XX+2	64.90	1,900,000	0
February 28, 20XX+2	65.30	1,800,000	0

March 31, 20XX+2	65.80	1,700,000	2,500,000
April 30, 20XX+2	66.00	1,600,000	4,500,000
May 31, 20XX+2	65.85	1,500,000	3,000,000
June 30, 20XX+2**	66.00	700,000	2,250,000
July 31, 20XX+2	65.60	650,000	250,000
August 31, 20XX+2	65.50	600,000	0
September 30, 20XX+2	65.75	550,000	1,000,000
October 31, 20XX+2	65.80	500,000	1,250,000
November 30, 20XX+2	65.85	450,000	1,500,000
December 31, 20XX+2***	65.90	400,000	1,750,000

\*This example does not address how the time value of options would be computed in practice.

\*\* Options for five million barrels exercised; remainder held until end of December, then sold.

\*\*\* Values cited are immediately prior to sale of remaining options.

At the end of June 20XX+2, Friendly Chemicals exercises options for five million barrels, paying €65.55 per barrel for oil that is then selling on world markets for €66.00 each. It holds the remaining options until December, when it sells these for an aggregate price of €2.1 million, a slight discount to the nominal fair value at that date.

The inventory acquired in mid-20XX+2 is processed and included in goods available-for-sale. Sales of these goods, in terms of the five million barrels of crude oil which were consumed in their production, are as follows:

<u>Date</u>	<u>Equivalent barrels sold in month</u>	<u>Equivalent barrels on hand at month-end</u>
June 30, 20XX+2	300,000	4,700,000
July 31, 20XX+2	250,000	4,450,000
August 31, 20XX+2	400,000	4,050,000
September 30, 20XX+2	350,000	3,700,000
October 31, 20XX+2	550,000	3,150,000
November 30, 20XX+2	500,000	2,650,000
December 31, 20XX+2	650,000	2,000,000

Based on the foregoing facts, the journal entries prepared on a *monthly* basis (for illustrative purposes) for the period December 20XX+1 through December 20XX+2 are as follows:

**December 31, 20XX+1**

Option contract	2,000,000	
Cash		2,000,000

*To record purchase premium on option contract for up to 10 million barrels of oil at price of €65.55 per barrel.*

**January 31, 20XX+2**

Gain/loss on hedging transaction	100,000	
Option contract		100,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment*

Option contract	0	
Other comprehensive income		0

*To reflect change in intrinsic value of option contracts (no value at this date).*

**February 28, 20XX+2**

Gain/loss on hedging transaction	100,000	
Option contract		100,000
<i>To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment</i>		
Option contract	0	
Other comprehensive profit or loss		0
<i>To reflect change in intrinsic value of option contracts (no value at this date).</i>		

**March 31, 20XX+2**

Gain/loss on hedging transaction	100,000	
Option contract		100,000
<i>To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment</i>		
Option contract	2,500,000	
Other comprehensive profit or loss		2,500,000
<i>To reflect change in intrinsic value of option contracts.</i>		

**April 30, 20XX+2**

Gain/loss on hedging transaction	100,000	
Option contract		100,000
<i>To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment.</i>		
Option contract	2,000,000	
Other comprehensive profit or loss		2,000,000
<i>To reflect change in intrinsic value of option contracts (further increase in value).</i>		

**May 31, 20XX+2**

Gain/loss on hedging transaction	100,000	
Option contract		100,000
<i>To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment.</i>		
Other comprehensive profit or loss	1,500,000	
Option contract		1,500,000
<i>To reflect change in intrinsic value of option contracts (decline in value).</i>		

**June 30, 20XX+2**

Gain/loss on hedging transaction	800,000	
Option contract		800,000
<i>To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term and does not qualify for hedge accounting treatment; since one-half the options were exercised in June, the remaining unexpensed time value of that portion is also entirely written off at this time.</i>		
Option contracts	1,500,000	
Other comprehensive income		1,500,000
<i>To reflect change in intrinsic value of option contracts (further increase in value) before accounting for exercise of options on five million barrels.</i>		

June 30 value of options before exercise		4,500,000
Allocation to oil purchased at €65.55		<u>2,250,000</u>
Remaining option valuation		<u>2,250,000</u>

*The allocation to exercised options will be used to adjust the carrying value of the inventory, and ultimately will be transferred to cost of goods sold as a contra cost, as the five million barrels are sold, at the rate of 45% per equivalent barrel.*

Inventory	327,750,000	
Cash		327,750,000

*To record purchase of five million barrels of oil at option price of €65.55/barrel.*

Inventory	2,250,000	
Option contract		2,250,000

*To increase the recorded value of the inventory to include the fair value of options given up in acquiring the oil (taken together, the cash purchase price and the fair value of options surrendered add to €66.00 per barrel, the world market price at date of purchase).*

Other comprehensive income	2,250,000	
Inventory		2,250,000

*To reclassify deferred gain from equity and include in initial measurement of inventory.*

Cost of goods sold	19,665,000	
Inventory		19,665,000

*To record cost of goods sold.*

#### **July 31, 20XX+2**

Gain/loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Other comprehensive income	2,000,000	
Option contract		2,000,000

*To reflect change in intrinsic value of remaining option contracts (decline in value).*

Cost of goods sold	16,387,500	
Inventory		16,387,500

*To record cost of goods sold.*

#### **August 31, 20XX+2**

Loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Other comprehensive income	250,000	
Option contract		250,000

*To reflect change in intrinsic value of remaining option contracts (decline in value).*

Cost of goods sold	26,220,000	
Inventory		26,220,000

*To record cost of goods sold.*

#### **September 30, 20XX+2**

Gain/loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Option contract	1,000,000	
Other comprehensive income		1,000,000
<i>To reflect change in intrinsic value of remaining option contracts (increase in value).</i>		
Cost of goods sold	22,942,500	
Inventory		22,942,500

*To record cost of goods sold.*

#### **October 31, 20XX+2**

Gain/loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Option contract	250,000	
Other comprehensive income		250,000
<i>To reflect change in intrinsic value of remaining option contracts (further increase in value).</i>		
Cost of goods sold	36,052,500	
Inventory		36,052,500

*To record cost of goods sold.*

#### **November 30, 20XX+2**

Gain/loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Option contract	250,000	
Other comprehensive income		250,000
<i>To reflect change in intrinsic value of remaining option contracts (further increase in value).</i>		
Cost of goods sold	32,775,000	
Inventory		32,775,000

*To record cost of goods sold.*

#### **December 31, 20XX+2**

Gain/loss on hedging transaction	50,000	
Option contract		50,000

*To record change in time value of option contract—charge premium to profit or loss since this represents payment for time value of money, which expires rateably over two-year term, and does not qualify for hedge accounting treatment.*

Option contract	250,000	
Other comprehensive income		250,000
<i>To reflect change in intrinsic value of remaining option contracts (further increase in value) before sale of options.</i>		
Cost of goods sold	42,607,500	
Inventory		42,607,500

*To record cost of goods sold.*

Cash	2,100,000	
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Loss on sale of options	50,000	
Option contract		2,150,000
Other comprehensive income	1,750,000	
Gain on sale of options		1,750,000

*To record sale of remaining option contracts; the cash price was €50,000 lower than carrying value of asset sold (options having unexpired time value of €400,000 plus intrinsic value of €1,750,000), but reclassification from equity to profit or loss recognizes formerly deferred gain; since no further inventory purchases are planned in connection with this hedging activity, the unrealized gain is recognized in profit or loss.*

### **Discontinuance of cash flow hedge accounting**

IAS 39 specifies that an entity must discontinue prospectively hedge accounting if:

- The hedging instrument expires, or is sold, terminated or exercised (see however similar exceptions under termination of a fair value hedge detailed above);
- The hedge no longer meets the IAS 39 criteria, e.g., is no longer highly effective;
- The forecast transaction is no longer expected to occur; or
- The entity de-designates the hedging relationship.

On discontinuance of a cash flow hedge, the cumulative gain or loss on the hedging instrument recognized in OCI continues to be carried under OCI until the forecast transaction occurs. Where the forecast transaction is not expected to occur, the cumulative gain or loss in OCI is reclassified from equity to profit or loss.

**Net investment hedge.** A net investment hedge is a hedge of foreign currency exposure that arises in consolidated financial statements only where the functional currency of the parent is different from that of the subsidiaries. Under IAS 21, the group share of net assets of a subsidiary with a different functional currency is retranslated into the functional currency of the parent and any exchange differences are recognized within other comprehensive income. Where the parent has an effective hedge against the net investment (commonly through foreign currency loans), in a manner similar to hedge accounting, IAS 39 permits that the gain or loss on the effective portion of the hedging instrument (the loan) is recognized under other comprehensive income rather than profit or loss.

The net investment in the foreign operation that is eligible to be treated as the hedged item comprises the net assets including goodwill and any other fair value adjustments arising on acquisition under IFRS 3 and any monetary items that are payable or receivable between the parent and the foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future.

#### **Example of hedging of a net investment in a foreign subsidiary**

IAS 39 permits hedging of a net investment in foreign subsidiaries (“net investment hedge”). For example, Swartzwald GmbH has a net investment of \$100,000 in its US subsidiary, Simpsons Inc., for which it paid €110,000 on January 1, 20XX. Swartzwald could hedge its net asset investment by entering, for example, into a forward exchange contract to sell US dollars, or the company could incur a US dollar-based liability. IAS 39 states that the gain or loss on the effective portion of a hedge of a net investment is reported in other comprehensive income and accumulated in equity as part of the foreign currency translation adjustment. However, the amount of offset to other comprehensive income is limited to the translation adjustment for the net investment. For example, if the forward exchange rate is used to measure hedge effectiveness, the amount of offset

is limited to the change in spot rates during the period. Any excess of the ineffective portion of the hedge must be recognized currently in profit or loss.

On January 1, 20XX, Swartzwald decided to hedge its investment in Simpsons for the amount equal to the book value of the US company's net investment (net assets). Swartzwald is unsure whether the exchange rate for the dollar will increase or decrease for the year and wants to hedge its net asset investment. On January 1, 20XX, Swartzwald's ownership share of Simpson's net assets is equal to \$100,000 (\$80,000 share capital and \$20,000 retained earnings). On that day Swartzwald borrows \$100,000, at a 5% rate of interest, to hedge its equity investment in the US company, and the principal and interest are due and payable on January 1, 20XX+1.

The spot exchange rates are	January 1, 20XX	\$1 = € 90
	December 31, 20XX	\$1 = € 80

The average exchange rate for the year 20XX is		\$1 = € 85
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The journal entries on Swartzwald's euro-denominated books to account for this hedge of a net investment are as follows:

#### January 1, 20XX

Cash	90,000	
Loan payable (\$ denominated debt)		90,000
<i>To record a dollar-denominated loan to hedge net investment in US subsidiary €90,000 = \$100,000 × € .90 spot rate.</i>		

#### December 31, 20XX

Loan payable (\$ denominated debt)	10,000	
Other comprehensive income (OCI)		10,000
<i>To revalue foreign currency-denominated payable to end-of-period spot rate €10,000 = \$100,000 × (€ .90 – € .80).</i>		
Interest expense	4,250	
Foreign currency exchange gain		250
Interest payable		4,000
<i>To accrue interest expense and payable on dollar loan</i>		
<i>€4,250 = \$100,000 × 0.05 interest × € .85 average exchange rate</i>		
<i>€4,000 = \$100,000 × 0.05 interest × € .80 ending spot rate</i>		
Other comprehensive income (OCI)	10,000	
Foreign currency exchange gain	250	
Profit or loss summary (retained earnings)		250
Translation adjustment—accumulated OCI		10,000
<i>To record closing of nominal accounts related to hedge of net investment in foreign subsidiary.</i>		

#### January 1, 20XX+1

Interest payable (\$ denominated debt)	4,000	
Loan payable (\$ denominated debt)	80,000	
Cash		84,000
<i>To record repayment of principal and interest. €80,000 = €90,000 – €10,000.</i>		

During 20XX the euro has strengthened relative to the dollar (the direct exchange rate has decreased from € 90 to € 80) and Swartzwald would recognize a loss on a net asset investment in dollars and gain on a liability payable in dollars. Without this hedge of the net investment, Swartzwald would report a €10,850 debit balance in other comprehensive income (the cumulative translation adjustment portion of accumulated other comprehensive income equals €10,000



+ €850 differential adjustment). With the hedge of its net investment, Swartzwald will report only €850 (€10,850 – €10,000 effect of hedge) as the change in the cumulative translation adjustment for 20XX. Note also that the amount of the offset to other income is limited to the effective portion of the hedge based on the revaluation of the net assets. Any excess, in this case the €250 gain on the revaluation of the interest payable, is reported currently in the profit or loss.

### ***Hedging on a “net” basis and “macrohedging”***

The IAS 39 Implementation Guidance Committee (IGC) has addressed the issue of whether a reporting entity can group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes. It ruled that while an entity’s hedging strategy and risk management practices may assess cash flow risk on a net basis, IAS 39 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IAS 39 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

In 2004 IASB amended IAS 39 to permit “macrohedging” (more formally, hedging a portfolio hedge of interest rate risk). This permits an entity to apply *fair value* hedging (but not cash flow hedging) to a grouping of assets and/or liabilities, which essentially means that the net exposure can be hedged, without a need to separately put hedge positions on for each of the individual assets and/or liabilities.

### ***Partial term hedging***

IAS 39 indicates that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. On the other hand, it is permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item. For example, if Aquarian Corp. acquires a 10% fixed-rate government bond with a remaining term to maturity of 10 years, and classifies the bond as available-for-sale, it may hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year five by acquiring a five-year “pay-fixed, receive-floating” swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year five and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

### ***Interest rate risk managed on a net basis should be designated as hedge of gross exposure***

If an entity manages its exposure to interest rate risk on a net basis, a number of complex financial reporting issues must be addressed, regarding the ability to use hedge accounting. The IGC has offered substantial guidance on a number of matters, the more generally applicable of which are summarized in the following paragraphs.

The IGC has concluded that a derivative that is used to manage interest rate risk on a net basis be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure under IAS 39. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets or liabilities or as a cash flow hedge of forecasted transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

The IGC also notes that firm commitments to purchase or sell assets at fixed prices create fair value exposures, but are accounted for as cash flow hedges. (Note, however, the IASB has proposed to reverse the former rule, such that hedges of firm commitments will henceforth be accounted for as fair value hedges.) In economic terms, it does not matter whether the derivative instrument is considered a fair value hedge or a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable-rate asset or a fair value hedge of a fixed-rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offsets the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed below.

Consider the following illustration. Among its financial resources and obligations, a bank has the following assets and liabilities having maturities of two years:

**Example**

	<u>Variable interest</u>	<u>Fixed interest</u>
Assets	60,000	100,000
Liabilities	(100,000)	(60,000)
Net	(40,000)	40,000

The bank enters into a two-year interest rate swap with a notional principal of €40,000 to receive a variable interest rate and pay a fixed interest rate, in order to hedge the net exposure of the two-year maturity financial assets and liabilities. According to the IGC, this may be designated either as a fair value hedge of €40,000 of the fixed-rate assets or as a cash flow hedge of €40,000 of the variable-rate liabilities. It cannot be designated as a hedge of the net exposure, however.

Determining whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure is based on a number of critical considerations. These include the assessment of hedge effectiveness in the presence of prepayment risk, and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items. For accounting purposes, the designation of the derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses differ for each of these categories. The IGC has observed that it will often be easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Another important issue involves the effects of prepayments on the fair value of an instrument and the timing of its cash flows, as well as the impacts on the effectiveness test for fair value hedges and the probability test for cash flow hedges, respectively. Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item. This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term, and the financial assets being hedged are subject to prepayment by the borrower.

Also, it may be difficult to conclude that, for a portfolio of fixed-rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment, but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. However, for accounting purposes, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements, without consideration of future adjustments to those positions. The fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecasted cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable, and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument. Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecasted transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecasted transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

The IGC has also emphasized that there are important systems considerations relating to the use of hedge accounting. It notes that the accounting differs for fair value hedges and cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest-sensitive assets and liabilities, may result in an adjustment of the effective yield of the hedged item. As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the hedged assets or liabilities being hedged in order to be able to recompute their effective yield, determine the subsequent amortization of the fair value adjustment to net profit or loss, and determine the amount that should be recognized in net profit or loss when assets are sold or liabilities extinguished. To comply with the requirements for fair value hedge accounting, it generally will be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective yield of the hedged items and amortize the changes to net profit or loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecasted transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognized in other

comprehensive income. To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the adjustments from changes in the fair value of a hedging instrument should be recognized in profit or loss. For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling out the changes in the cash flows of the derivative and the recognition of such changes in profit or loss. The timing of the recognition in profit or loss can be predetermined when the hedge is associated with the exposure to changes in cash flows.

The forecasted transactions that are being hedged can be associated with a specific principal amount in specific future periods, composed of variable-rate assets and cash inflows being reinvested or variable-rate liabilities and cash outflows being refinanced, each of which create a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rate are matched with the derivative hedging instrument. IAS 39 specifies that the amounts recognized in other comprehensive income should be included in profit or loss in the same period or periods during which the hedged item affects profit or loss.

If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, the documentation required by IAS 39 would include information about the hedging relationship; the entity's risk management objective and strategy for undertaking the hedge; the type of hedge; the hedged item; the hedged risk; the hedging instrument; and the method of assessing effectiveness.

Information about the hedging relationship would include the maturity schedule of cash flows used for risk management purposes; to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship. The entity's risk management objective and strategy for undertaking the hedge would be addressed in terms of the entity's overall risk management objective, and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy. The fact that the hedge is a cash flow hedge would also be noted.

The hedged item will be documented as a group of forecasted transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for instance, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. The forecasted transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based off the same yield curve as the derivative hedging instrument.

Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecasted transactions occurring in the specified future periods designated as being hedged.

The method of assessing effectiveness is documented by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecasted transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

When a hedging relationship is designated as a cash flow hedge, the entity might satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

If the hedging relationship is designated as a cash flow hedge, an entity may demonstrate a high probability of the forecasted transactions occurring by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecasted transactions that are designated as being hedged are highly probable of occurring. Such a schedule should be supported by management's stated intent and past practice of reinvesting cash inflows and refinancing cash outflows.

For instance, an entity may forecast aggregate gross cash inflows of €10,000 and aggregate gross cash outflows of €9,000 in a particular time period in the near future. In this case, it may wish to designate the forecasted reinvestment of gross cash inflows of €1,000 as the hedged item in the future time period. If more than €1,000 of the forecasted cash inflows are contractually specified and have low credit risk, the entity has very strong evidence to support an assertion that gross cash inflows of €1,000 are highly probable of occurring and support the designation of the forecasted reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecasted transactions occurring may also be demonstrated under other circumstances.

If the hedging relationship is designated as a cash flow hedge, an entity will assess and measure effectiveness under IAS 39, at a minimum, at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated, to ensure that the recognition in net profit or loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecasted transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged. The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognized initially in other comprehensive income are reclassified out of equity and recognized in profit or loss.

Since forecasted transactions will have different terms when they occur, including credit exposures, maturities and option features, there may be an issue over how an entity can satisfy the tests in IAS 39 requiring that the hedged group have similar risk characteristics. According to the IGC, the standard provides for hedging a group of assets, liabilities, firm commitments or forecasted transactions with similar risk characteristics. IAS 39 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecasted transactions. For hedges of cash flow exposures relating to a group of forecasted transactions, the overall exposure of the forecasted transactions and the assets or liabilities that are repricing may have very different risks. The exposure from forecasted transactions may differ based on the terms that are expected as they relate to credit exposures, maturities, options, and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (that is, the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit-rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety.

For example, if a portfolio of assets consists of assets rated A, BB, and B, and the current market interest rates for these assets are LIBOR + 20 basis points, LIBOR + 40 basis points and LIBOR + 60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments are made based on LIBOR to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

**Designation of non-financial items.** IAS 39 specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the risks attributable to a specific risk.

For example, entity A, with a functional currency of \$, could enter into a contract to purchase processed flour from entity B which has a euro functional currency. The transaction will be invoiced in euros. As the processed flour is a non-financial item, entity A can either

designate only the foreign currency element of the transaction as a cash flow hedge, or alternatively hedge the entire purchase assuming availability of a suitable hedging instrument. It cannot hedge separately for the global price changes in wheat within this transaction.

**Hedging own equity.** An entity's own equity cannot be designated as a hedge item because it does not affect profit or loss. This includes forecast dividend payments and similar equity transactions that are not formally declared and payable. However, dividend that is formally declared and recognized as a liability can be designated potentially for foreign exchange risk.

**Investments in associates, joint ventures and subsidiaries.** Such investment cannot be designated as hedged items in consolidated financial statements because such financial statements recognize share of profit and not changes in fair value. However, such investments can be designated as hedged items for fair value hedges in separate financial statements dependent on meeting the IAS 39 criteria for hedge accounting. Note however that net investment hedges are available to consolidated groups as discussed in more detail above.

**Hedge effectiveness.** To meet the hedge accounting criteria under IAS 39, the hedging relationship needs to be "highly effective" at the inception of the hedge (prospectively) and during the duration and at the end of the hedge (retrospectively).

IAS 39 requires that an entity assess the hedge effectiveness prior to and over the course of the duration. While the standard does not prescribe a single methodology for this assessment, it requires that the entity select a suitable method in line with the risk management strategies and objectives and apply it consistently over the hedging duration. The same method needs to be applied to all similar hedges. For hedge accounting to be permissible, the hedge needs to be highly effective, which under IAS 39 AG 105 will be the case only when the following conditions are met:

- At inception, and in subsequent periods, the hedge is expected to be highly effective in achieving the offsets in the fair values or cash flows (depending on the nature of the hedge) and that such an expectation is demonstrated through:
  - Past experience of similar hedging relationships;
  - High level of statistical correlation; or
  - Other means including ratio analysis, etc.
- The actual results of the effectiveness assessment above indicate results within 80–125%.

Where the hedge is found to be effective within the 80–125% range, the effective portion qualifies for the elected hedge accounting. The ineffective portion however will not qualify for hedge accounting and will need to be recognized in profit or loss.

Where the hedge effectiveness falls outside of the 80–125% range at inception, hedge accounting will not be permissible. If the effectiveness is within this range at inception but subsequently falls out of this range, hedge accounting will be discontinued for that period and also for any subsequent period unless the hedge is redesignated and considered to be effective within the range above going forward.

A useful and easier way to manage hedge effectiveness assessment at inception is through critical terms matching. For certain types of hedge relationships, it will be easy to

demonstrate that the critical terms of the hedged item and the instrument match will result in a high degree of offset and therefore the hedge will be highly effective. Note however that even where using critical terms matching, retrospective testing is still required and any effectiveness within the 80–125% range is still recognized in profit or loss.

#### Example of critical terms matching

An entity with a functional currency of GBP seeks to hedge foreign currency risk of a firm commitment to buy 100 barrels of oil on June 30, 20XX (six months after its year-end) at a total cost of US \$5,000 (the hedged item). The entity enters into a foreign currency forward contract selling GBP 3,500 in six months' time (June 30, 20XX) in exchange for US \$5,000 and designates this as a hedge of the foreign currency risk for the firm commitment above. As all the primary critical terms (duration, maturity dates, and values) match, such a hedge is expected to be highly effective at inception.

**Documentation requirements.** A critical criterion of IAS 39 in permitting hedge accounting is the stringent documentation requirements. IAS 39 requires that sufficient documentation be in place at the inception of the hedge relationship and that until such documentation is in place, an entity cannot apply hedge accounting. Therefore, such documentation cannot be established on a retrospective basis.

IAS 39 requires such documentation to comprise:

- Documentation at each hedge relationship level which will include details of the hedging instrument, the hedged item or transaction, the nature of risk being hedged and the methodology that will be used to assess effectiveness of the hedging relationship; and
- Overall risk management policies and procedures under which the hedges are undertaken.

## DISCLOSURE

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### Disclosures Required under IFRS 7

IAS 32 established an expansive set of disclosure requirements. IAS 39 carried forward these requirements with only minor changes and added further informational disclosure requirements. Both IAS 32 and IAS 39 were revised as part of the IASB's *Improvements Project* in 2003, and at that time all disclosure requirements were relocated to IAS 32. In mid-2005, IFRS 7 was promulgated, which set forth all financial instruments disclosure requirements, superseding (but not changing) the disclosure requirements previously found in both IAS 30 and IAS 32.

IFRS 7 has superseded the disclosure requirements previously found in IAS 32, as well as the financial institution-specific disclosure requirements of IAS 30, which were accordingly withdrawn. Presentation requirements set forth in IAS 32 continue in effect under that standard. IFRS 7 became effective for years beginning in 2007. Some of the amendments to IFRS 7 since 2007 are highlighted below:

- Improving disclosures about financial instruments issued in March 2009 amended the required disclosures of fair value measurement and liquidity risk.



- Improvements to IFRSs issued in May 2010 included amendments to IFRS 7 that mostly clarified and refined certain disclosure requirements. Amendments are effective for financial periods beginning on or after 01.01.2011.
- Transfer of financial assets issued in October 2010 on transfer of financial assets determining the recognition or derecognition (effective financial periods beginning on or after 01.07.2011).
- IFRS 13, *Fair Value Measurement* which transferred all the fair value disclosure from IFRS 7 to IFRS 13 (effective for financial periods beginning on or after 01.01.2013).
- The latest amendments to IFRS 7 effective January 1, 2013 require entities to disclose information about rights of offset and related arrangements for financial instruments under an enforceable master netting agreement or similar arrangements irrespective of whether they are offset in the statement of financial position.

IFRS 7 was made necessary by the increasingly sophisticated (but opaque) methods that reporting entities had begun using to measure and manage their exposure to risks arising from financial instruments. At the same time, new risk management concepts and approaches have gained acceptance. IASB concluded that users of financial statements need information about the reporting entities' exposures to risks and how those risks are being managed.

The principal objectives of this standard are to enable users to evaluate and assess:

- Significance of financial instruments to an entity's financial position and subsequent performance;
- Nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

Risk management information can influence the users' assessments of the financial position and performance of reporting entities, as well as of the amount, timing and uncertainty of the respective entity's future cash flows. In short, greater transparency regarding those risks allows users to make more informed judgements about risk and return. This is entirely consistent with the fundamental objective of financial reporting and is consistent with the widely accepted efficient markets hypothesis.

Paragraph 7 of IFRS 7 requires an entity to disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial performance and financial position. Therefore, IFRS 7 applies to all risks arising from all financial instruments, with limited exceptions. It furthermore applies to all entities, including those that have only few basic financial instruments (e.g., an entity whose only financial instruments are accounts receivable and payable), as well as those that have many complex financial instruments (e.g., a financial institution, most assets and liabilities of which are financial instruments). Under IFRS 7, the extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk.

IFRS 7 sets out the requirements for the disclosure of financial instruments under two broad categories, quantitative disclosures and qualitative disclosures. The quantitative disclosures provide information about the effect of financial instruments on the financial position and financial performance of the entity, whereas the qualitative disclosures provide useful information about how risks relating to financial instruments arise in the entity and

how these risks are being managed. The nature of the reporting entity's business and the extent to which it holds financial assets or is obligated by financial liabilities will affect the manner in which such disclosures are presented, and no single method of making such disclosures will be suitable for every entity. The standard therefore adopts an approach that requires the entity to disclose the information required in the form that it is presented internally for use by management and in those areas where management does not prepare the required information it must develop the appropriate disclosures. This approach means that financial instrument disclosures may not be easily comparable between entities.

The risks arising from financial instruments are categorized as follows:

1. **Market risk**, which implies not merely the risk of loss but also the potential for gain, and which is in turn comprised of:
  - a. **Currency risk**—The risk that the value of an instrument will vary due to changes in currency exchange rates.
  - b. **Interest rate risk**—The risk that the value of the instrument will fluctuate due to changes in market interest rates. Interest rate risk is the risk associated with holding fixed-rate instruments in a changing interest-rate environment. As market rates rise, the price of fixed-interest-rate instruments will decline, and vice versa. This relationship holds in all cases, irrespective of other specific factors, such as changes in perceived creditworthiness of the borrower. However, with certain complex instruments such as mortgage-backed bonds (a popular form of derivative instrument), where the behaviour of the underlying debtors can be expected to be altered by changes in the interest rate environment (i.e., as market interest rates decline, prepayments by mortgagors increase in frequency, raising reinvestment rate risk to the bondholders and accordingly tempering the otherwise expected upward movement of the bond prices), the inverse relationship will become distorted.
  - c. **Other price risk**—A broader concept that subsumes interest rate risk, this is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to factors specific to the financial instrument or due to factors that are generally affecting all similar instruments traded in the same markets (e.g., where financial instruments comprise derivative contracts in commodity markets, such price risk will include the risks of changes in the respective commodity prices on international markets).
2. **Credit risk** is related to a loss that may occur from the failure of another party to a financial instrument to discharge an obligation according to the terms of a contract.
3. **Liquidity risk** is the risk that an entity may encounter difficulty in meeting obligations associated with financial liabilities.

### *Exceptions to applicability*

IFRS 7 identifies the following types of financial instruments to which the requirements do not apply:

1. Interests in subsidiaries, associates and joint ventures accounted for in accordance with IFRS 10, IFRS 11, IAS 27 or IAS 28, respectively. However, given that in some cases those standards permit an entity to account for an interest in a subsidiary, associate or joint venture using IAS 39, in those cases the reporting entities are to

apply the disclosure requirements in those other standards as well as those in IFRS 7. Entities are also to apply IFRS 7 to all derivatives linked to interests in subsidiaries, associates or joint ventures, unless the derivative meets the definition of an equity instrument first established by IAS 32.

2. Employers' rights and obligations arising from employee benefit plans, to which IAS 19 applies.
3. Contracts for contingent consideration in a business combination, per IFRS 3, in financial reporting by the acquirer.
4. Insurance contracts as defined in IFRS 4. However, IFRS 7 applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately.
5. Financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 applies, except that IFRS 7 applies to certain contracts that are within the scope of IAS 39.

### ***Applicability***

IFRS 7 applies to both recognized and unrecognized financial instruments. *Recognized* financial instruments include financial assets and financial liabilities that are within the scope of IAS 39. *Unrecognized* financial instruments include some financial instruments that, although outside the scope of IAS 39, are within the scope of this IFRS (such as some loan commitments). The requirements also extend to contracts involving non-financial items if they are subject to IAS 39.

### ***Classes of financial instruments and level of disclosure***

Many of the IFRS 7 requirements pertain to grouped data. In such cases, the grouping into classes is to be effected in the manner that is appropriate to the nature of the information disclosed and that takes into account the characteristics of the financial instruments. Importantly, sufficient information must be provided so as to permit reconciliation to the line items presented in the statement of financial position. Enough detail is required so that users are able to assess the significance of financial instruments to the reporting entity's financial position and results of operations.

IFRS 7 requires that carrying amounts of each of the following categories, as defined in IAS 39, are to be disclosed either on the face of the statement of financial position or in the notes:

1. Financial assets at fair value through profit or loss, showing separately:
  - a. Those designated as such upon initial recognition via the "fair value option"; and
  - b. Those classified as held-for-trading in accordance with IAS 39;
2. Held-to-maturity investments;
3. Loans and receivables;
4. Available-for-sale financial assets;
5. Financial liabilities at fair value through profit or loss, showing separately:
  - a. Those designated as such upon initial recognition via the "fair value option"; and
  - b. Those classified as held-for-trading in accordance with IAS 39; and
  - c. Financial liabilities carried at amortized cost.

Below is an illustration of the requirement of IFRS 7 paragraph 8 disclosing the carrying amount of each category of financial instrument under IAS 39:

	Loans and receivables	Held-to- maturity	Held for trading	Designated at fair value through profit or loss	Derivatives used for hedging	Available- for-sale	Non-financial assets	Total
<b>Assets</b>								
Cash and balances with central banks	xx	xx	xx	xx	xx	xx	xx	xx
Treasury bills	xx	xx	xx	xx	xx	xx	xx	xx
Loans to credit institutions	xx	xx	xx	xx	xx	xx	xx	xx
Loans to the public	xx	xx	xx	xx	xx	xx	xx	xx
Interest-bearing securities	xx	xx	xx	xx	xx	xx	xx	xx
Financial instruments pledged as collateral	xx	xx	xx	xx	xx	xx	xx	xx
Shares	xx	xx	xx	xx	xx	xx	xx	xx
Derivatives	xx	xx	xx	xx	xx	xx	xx	xx
Fair value changes of the hedged items in portfolio hedge of interest rate risk	xx	xx	xx	xx	xx	xx	xx	xx
Investment in associate undertakings	xx	xx	xx	xx	xx	xx	xx	xx
Intangible assets	xx	xx	xx	xx	xx	xx	xx	xx
Property and equipment	xx	xx	xx	xx	xx	xx	xx	xx
Investment property	xx	xx	xx	xx	xx	xx	xx	xx
Deferred tax assets	xx	xx	xx	xx	xx	xx	xx	xx
Current tax assets	xx	xx	xx	xx	xx	xx	xx	xx
Retirement benefit assets	xx	xx	xx	xx	xx	xx	xx	xx
Other assets	xx	xx	xx	xx	xx	xx	xx	xx
Prepaid expenses and accrued income	xx	xx	xx	xx	xx	xx	xx	xx
<b>TOTAL</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>
<b>Liabilities</b>								
		Held for trading	Designated at fair value through profit or loss	Derivatives used for hedging	Other financial liabilities	Non- financial liabilities		Total
Deposits by credit institutions		xx	xx	xx	xx	xx		xx
Deposits and borrowings from the public		xx	xx	xx	xx	xx		xx
Liabilities to policyholders		xx	xx	xx	xx	xx		xx

Debt securities in issue	xx	xx	xx	xx	xx	xx
Derivatives	xx	xx	xx	xx	xx	xx
Fair value changes of the hedged items in portfolio hedge of interest rate risk	xx	xx	xx	xx	xx	xx
Current tax liabilities	xx	xx	xx	xx	xx	xx
Other liabilities	xx	xx	xx	xx	xx	xx
Accrued expenses and prepaid income	xx	xx	xx	xx	xx	xx
Deferred tax liabilities	xx	xx	xx	xx	xx	xx
Provisions	xx	xx	xx	xx	xx	xx
Retirement benefit obligations	xx	xx	xx	xx	xx	xx
Subordinated liabilities	xx	xx	xx	xx	xx	xx
TOTAL	xx	xx	xx	xx	xx	xx

Special disclosures apply to those financial assets and liabilities accounted for by the “fair value option.” If the reporting entity designated a loan or receivable (or groups thereof) to be reported at fair value through profit or loss, it is required to disclose:

1. The maximum exposure to *credit risk* of the loan or receivable (or group thereof) at the reporting date.
2. The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
3. The amount of change, both during the reporting period *and* cumulatively, in the fair value of the loan or receivable (or group thereof) that is attributable to *changes in the credit risk* of the financial asset determined either:
  - a. As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
  - b. Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

4. The amount of the change in the fair value of any related derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

If the reporting entity has designated a financial liability to be reported at fair value through profit or loss, it is to disclose:

1. The amount of change, both during the period *and* cumulatively, in the fair value of the financial liability that is attributable to *changes in the credit risk* of that liability determined either:
  - a. As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

- b. Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate, or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

2. The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

### ***Reclassifications***

If a financial asset has been reclassified to one that is measured: (1) at cost or amortized cost, rather than at fair value; or (2) at fair value, rather than at cost or amortized cost, the amount reclassified into and out of each category and the reason for that reclassification are to be disclosed. Although IFRS 7 does not seem to enforce disclosures on financial liabilities reclassifications, it is always good practice to do so. A reason for the reclassification would be necessary and to define the circumstances that led to the reclassification.

### ***Certain derecognition matters***

If financial assets were transferred in such a way that part or all of those assets did not qualify for derecognition under IAS 39, the following disclosures are required for each class of such financial assets:

1. The nature of the assets;
2. The nature of the risks and rewards of ownership to which the entity remains exposed;
3. When the entity continues to recognize all of the assets, the carrying amounts of the assets and of the associated liabilities; and
4. When the entity continues to recognize the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognize, and the carrying amount of the associated liabilities.

### ***Collateral***

The reporting entity must disclose the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with the provision of IAS 39 pertaining to rights to repledge; and the terms and conditions relating to its pledge.

Conversely, if the reporting entity holds collateral (of either financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it must now disclose the fair value of the collateral held and the fair value of any such collateral sold or repledged, and whether it has an obligation to return it; and the terms and conditions associated with its use of the collateral.

### ***Allowances for bad debts or other credit losses***

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (whether associated with a specific asset or for the collective

impairment of assets), rather than directly reducing the carrying amount of the asset, it is to disclose a reconciliation of changes in that account during the period, for each class of financial assets.

### ***Certain compound instruments***

If the reporting entity is the *issuer* of compound instruments, such as convertible debt, having multiple embedded derivatives having interdependent values (such as the conversion feature and a call feature, such that the issuer can effectively force conversion), these matters must be disclosed.

### ***Defaults and breaches***

If the reporting entity is the obligor under loans payable at the date of the statement of financial position, it must disclose:

1. The details of any defaults during the period, involving payment of principal or interest, or into a sinking fund, or of the redemption terms of those loans payable;
2. The carrying amount of the loans payable in default at the reporting date; and
3. Whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorized for issue.

Similar disclosures are required for any other breaches of loan agreement terms, if such breaches gave the lender the right to accelerate payment, unless these were remedied or terms were renegotiated before the reporting date.

### ***Disclosures in the statements of comprehensive income and changes in equity***

The reporting entity is to disclose the following items of revenue, expense, gains or losses, either on the face of the financial statements or in the notes thereto:

1. Net gain or net losses on:
  - a. Financial assets or financial liabilities carried at fair value through profit or loss, showing separately those incurred on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held-for-trading in accordance with IAS 39;
  - b. Available-for-sale financial assets, showing separately the amount of gain or loss recognized in other comprehensive income during the period and the amount reclassified from equity and recognized in profit or loss for the period;
  - c. Held-to-maturity investments;
  - d. Loans and receivables; and
  - e. Financial liabilities carried at amortized cost.
2. Total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not carried at fair value through profit or loss;
3. Fee income and expense (other than amounts included in determining the effective interest rate) arising from:
  - a. Financial assets or financial liabilities that are not carried at fair value through profit or loss; and

- b. Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions.
4. Interest income on impaired financial assets accrued in accordance with the provision of IAS 39 that stipulates that, once written down for impairment, interest income thereafter is to be recognized at the rate used to discount cash flows in order to compute impairment; and
5. The amount of any impairment loss for each class of financial asset.

#### ***Accounting policies disclosure***

The reporting entity is to disclose the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

#### ***Hedging disclosures***

Hedge accounting is one of the more complex aspects of financial instruments accounting under IAS 39. IFRS 7 specifies that an entity engaged in hedging must disclose, separately for each type of hedge described in IAS 39 (i.e., fair value hedges, cash flow hedges and hedges of net investments in foreign operations):

1. A description of each type of hedge;
2. A description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and
3. The nature of the risks being hedged.

In the case of cash flow hedges, the reporting entity is to disclose:

1. The periods when the cash flows are expected to occur and when they are expected to affect profit or loss;
2. A description of any forecasted transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
3. The amount that was recognized in other comprehensive income during the period;
4. The amount that was reclassified from equity and included in profit or loss for the period, showing the amount included in each line item in the statement of comprehensive income; and
5. The amount that was reclassified from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

The reporting entity is to disclose separately:

1. For fair value hedges, gains or losses:
  - a. From the hedging instrument; and
  - b. From the hedge item attributable to the hedged risk.
2. The ineffectiveness recognized in profit or loss that arises from cash flow hedges; and
3. The ineffectiveness recognized in profit or loss that arises from hedges of net investments in foreign operations.



**Fair value disclosures**

IFRS 7 requires that for each class of financial assets and financial liabilities, the reporting entity is to disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. Grouping by class is required, but offsetting assets and liabilities is generally not permitted (but will conform to statement of financial position presentation).

As mentioned above, most of the detailed fair value disclosures previously contained within IFRS 7 were transferred to IFRS 13 with limited amendments/changes. IFRS 13 requires disclosure that helps users of its financial statements assess:

- a. For assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used to develop those measurements;
- b. For recurring fair value measurements where the primary inputs are unobservable (Level 3), detailed movement analysis showing the effects on profit or loss during the reporting period.

The following are the disclosures required to meet the objectives above:

1. The methods and, if a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities (e.g., as to prepayment rates, rates of estimated credit losses, and interest rates or discount rates).
2. Whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique.
3. Whether the fair values recognized or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are *not* supported by prices from observable current market transactions in the same instrument (that is, without modification or repackaging) and *not* based on available observable market data. If fair values are recognized in the financial statements, and if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, then this fact must be stated, and the effect of those changes must be disclosed. Significance is to be assessed in light of the entity's profit or loss, and total assets or total liabilities, or, total comprehensive income and equity, when changes in fair value are recognized in other comprehensive income.
4. If 3. applies, the total amount of the change in fair value estimated using such a valuation technique that was recognized in profit or loss during the period.

	Assets and liabilities measured at fair value in the statement of financial position after the date of initial recognition		Fair value disclosed in the notes to the financial statements
	Recurring	Non-recurring	
Fair value at the reporting date [IFRS 13:93 (a) & 97, IFRS 7.25]	✓	✓	✓

Reason for the fair value measurement [IFRS 13:93(a)]		✓	
The level of the fair value measurement in the fair value hierarchy [IFRS 13:93(b)]	✓	✓	✓
For Levels 2 and 3 measurements, a description of the valuation techniques and inputs used [IFRS 13:93(d)]	✓	✓	✓
For Level 2 and 3 measurements for which there has been a change in valuation technique, the nature of that change, and the reason for it [IFRS 13:93(d)]	✓	✓	✓
Information sufficient to permit reconciliation between the amounts disclosed for classes of assets and liabilities by level of the fair value hierarchy and the line items presented in the statement of financial position [IFRS 13:94]	✓	✓	✓
If an entity chooses as its accounting policy to use the portfolio valuation exception permitted by IFRS 13:48, that fact [IFRS 13:96]	✓		
For a liability measured at fair value, the existence of any credit enhancement and whether it is reflected in the fair value measurement of the liability [IFRS 13:98]	✓	✓	

The table below summarizes the Level 3 disclosures only:

	Assets and liabilities measured at fair value in the statement of financial position after the date of initial recognition	Fair value disclosed in the notes to the financial statements
Quantitative information about the significant unobservable inputs used in the fair value measurement [IFRS 13:93(d)]	✓	✓
Recognition of movements in fair value from opening to closing balances, showing separately: total gains and losses recognized in profit or loss (including the line items in profit or loss); total gains and losses recognized in other comprehensive income; purchase, sales, issues, settlements (each disclosed separately); and the amounts of transfers into and out of Level 3 and the entity's policy for determining that transfer has occurred [IFRS 13:93(e)]	✓	

<p>Amount of total gains or losses for the period recognized in profit or loss that is attributable to the change in unrealized gains or losses for those assets and liabilities held at the end of the reporting period, and the line items in profit or loss in which the gains or losses are recognized [IFRS 13:93(f)]</p>	✓	
<p>Description of the valuation processes used, including a description of how an entity decides on valuation policies and procedures and how it analyses changes in fair value from period to period [IFRS 13:93(g)]</p>	✓	✓
<p>Narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs might result in a significantly different fair value measurement and description of the interrelationships between those inputs, if any, including how those interrelationships might magnify or mitigate the impact on fair value arising from changes in such inputs. The narrative description of the sensitivity should include, at a minimum, all significant unobservable inputs used in the fair value measurement [IFRS 13:93(h) (i)]</p>	✓	
<p>For financial assets and liabilities, when a change in one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, that fact, the effect of those changes, and how the effect of such a change is calculated [IFRS 13:93(h) (ii)]</p>	✓	

In instances where the market for a financial instrument is not active, the reporting entity establishes the fair value using a valuation technique. The best evidence of fair value at initial recognition is the transaction price, so there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. In such a case, disclosure is required, by the class of financial instrument of:

1. The entity's accounting policy for recognizing that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price; and
2. The aggregate difference yet to be recognized in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

Disclosures of fair value are not required in these circumstances:

1. When the carrying amount is a reasonable approximation of fair value (e.g., for short-term trade receivables and payables);
2. For an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with IAS 39 because its fair value cannot be measured reliably; or
3. For an insurance contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.

In instances identified in 2. and 3. immediately above, the reporting entity must disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

1. The fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
2. A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
3. Information about the market for the instruments;
4. Information about whether and how the entity intends to dispose of the financial instruments; and
5. If financial instruments whose fair value previously could not be reliably measured are derecognized, their carrying amount at the time of derecognition, and the amount of gain or loss recognized.

In January 2009 the IASB issued amendments to IFRS 7 requiring additional information to be disclosed with respect to the fair value of financial instruments (this requirement was subsequently transferred to IFRS 13). The amendments required financial instruments measured at fair value to be categorized within a hierarchy of "fair values" much in line with the requirements under US GAAP Statement SFAS 157, *Fair Value Measurements*.

1. Level 1. Fair values determined from observable prices quoted in an active market.
2. Level 2. Fair values evidenced by comparison to other observable current market transactions in the same instrument (without modification) or based on a valuation technique whose variables include only data from observable markets.
3. Level 3. Financial instruments whose fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (without modification) and not based on available observable market data.

An entity is also required to disclose the movement of financial instruments in between these levels as well as disclosure of gains or losses recognized in profit or loss or other comprehensive income relating in particular to financial instruments in Level 3. These disclosure amendments above did not amend any of the recognition and measurement requirements of IAS 39.

**Example 1**

**38.3.2. Financial assets and liabilities that are not measured at fair value on a recurring basis**

**Fair value measurement as at 31 December 20XX**

	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Trade and other receivables	-	X	-	X
Cash and cash equivalents	X	-	-	X
<b>Financial liabilities</b>				
<b>Financial liabilities held at amortized costs</b>				
Bank loans	-	-	X	X
Loans from other entities	-	-	X	X
Trade and other payables	-	X	-	X
Finance lease payables	-	X	-	X

**Fair value measurement as at 31 December 20XX-1**

	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Trade and other receivables	-	X	-	X
Cash and cash equivalents	X	-	-	X
<b>Financial liabilities</b>				
<b>Financial liabilities held at amortized costs</b>				
Bank loans	-	-	X	X
Loans from other entities	-	-	X	X
Trade and other payables	-	X	-	X
Finance lease payables	-	X	-	X

***Disclosures about the nature and extent of risks flowing from financial instruments***

Reporting entities are required to disclose various information that will enable the users to evaluate the nature and extent of risks the reporting entity is faced with as a consequence of financial instruments it is exposed to at the date of the statement of financial position. Both qualitative and quantitative disclosures are required under IFRS 7, as described in the following paragraphs.

***Qualitative disclosures***

For each type of risk arising from financial instruments, the reporting entity is expected to disclose:

1. The exposures to risk and how they arise;

2. Its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
3. Any changes in 1. or 2. from the previous period.

### ***Quantitative disclosures***

For each type of risk arising from financial instruments, the entity must present:

1. Summary quantitative data about its exposure to that risk at the reporting date. This is to be based on the information provided internally to key management personnel of the entity.
2. The disclosures required as set forth below (credit risk, et al.), to the extent not provided in 1., unless the risk is not material.
3. Concentrations of risk, if not apparent from 1. and 2.

If the quantitative data disclosed as of the date of the statement of financial position are not representative of the reporting entity's exposure to risk during the period, it must provide further information that is representative.

Specific disclosures are mandated, concerning credit risk liquidity risk and market risk. These are set forth as follows in IFRS 7:

### ***Credit risk disclosures***

To be disclosed, by class of financial instrument, are:

1. The amount that best represents the entity's maximum exposure to credit risk at the reporting date, before taking into account any collateral held or other credit enhancements;
2. In respect of the amount disclosed, a description of collateral held as security and other credit enhancements;
3. Information about the credit quality of financial assets that are *neither* past due *nor* impaired; and
4. The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

**Regarding financial assets that are either past due or impaired**, the entity must disclose, again by class of financial asset:

1. An analysis of the age of financial assets that are past due as of the date of the statement of financial position but which are not judged to be impaired;
2. An analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors that the entity considered in determining that they are impaired; and
3. For the amounts disclosed in 1. and 2., a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

**Regarding any collateral and other credit enhancements obtained**, if these meet recognition criteria in the relevant IFRS, the reporting entity is to disclose:

1. The nature and carrying amount of the assets obtained; and

2. If the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

**Disclosure Example: Credit Risk**

**The groups, maximum exposure to credit risk, without taking into account any collateral held or other credit enhancements:**

	20XX	20XX-1
<b>Financial assets</b>		
Trade receivables	X	X
Other current assets	X	X
Other financial assets at fair value through profit and loss	X	X
Cash and cash equivalents	X	X
<b>Other credit risk exposures</b>		
Joint venture bank loan guarantee	X	X

The debtors' age analysis is also evaluated on a regular basis for potential doubtful debts, and the group purchases credit guarantee insurance, where this is considered necessary. It is management's opinion that no further provision for doubtful debts is required.

**An analysis of trade receivables**

	Carrying amount	Neither impaired nor past due	Past due but not impaired		
			61-90 days	91-120 days	More than 121 days
<b>20XX</b>					
Trade receivables	X	X	X	X	X
<b>20XX-1</b>					
Trade receivables	X	X	X	X	X

**Liquidity risk**

The entity is to disclose:

1. A maturity analysis for financial liabilities that shows the remaining contractual maturities; and
2. A description of how the entity manages the liquidity risk inherent in 1.

**Disclosure Example: Liquidity Risk**

The group maintains sufficient cash and marketable securities. Management review cashflow forecasts on a regular basis to determine whether the group has sufficient cash reserves to meet future working capital requirements and to take advantage of business opportunities. The group has further undrawn banking facilities of £X (2011: £X) which can be used as an additional means of easing liquidity risk if considered necessary. The average creditor payment period is X days (2011: X days).

**Contractual maturity analysis for financial liabilities**

<b>20XX</b>	<b>Due or due in less than 1 month</b>	<b>Due between 1 to 3 months</b>	<b>Due between 3 months to 1 year</b>	<b>Due between 1 to 5 years</b>	<b>Due after 5 years</b>	<b>Total</b>
Financial liabilities	-	-	-	X	X	X
Non-current borrowings	X	X	-	-	-	X
Trade and other payables	-	-	X	-	-	X
Current borrowings	X	X	X	-	-	X
Current portion of non-current borrowings	X	X	X	-	-	X
Finance lease liability	X	X	X	X	X	X
	X	X	X	X	X	X
<b>20XX-1</b>	<b>Due or due in less than 1 month</b>	<b>Due between 1 to 3 months</b>	<b>Due between 3 months to 1 year</b>	<b>Due between 1 to 5 years</b>	<b>Due after 5 years</b>	<b>Total</b>
<b>Financial liabilities</b>						
Non-current borrowings	-	-	-	X	X	X
Trade and other payables	X	X	-	-	-	X
Current portion of non-current borrowings	X	X	X	-	-	X
Finance lease liability	X	X	X	X	X	X
	X	X	X	X	X	X

**Market risk**

A number of informative disclosures are mandated, as described in the following paragraphs. *Sensitivity analysis* is generally required, as follows:

1. A sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
2. The methods and assumptions used in preparing the sensitivity analysis; and
3. Changes from the previous period in the methods and assumptions used, and the reasons for such changes.

If the reporting entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g., between interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in the preceding paragraph. The entity would also have to disclose:

1. An explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and



2. An explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

**Disclosure Example: Sensitivity Analysis**

Interest rate exposure and sensitivity analysis:

20XX	Carrying amount	Average interest rate %	If interest rates were X% higher		If interest rates were X% lower	
			Net profit	Equity	Net profit	Equity
<b>Financial assets</b>						
Trade receivables	X	X	X	X	X	X
Other financial assets at fair value through profit and loss	X	X	X	X	X	X
Cash and cash equivalents	X	X	X	X	X	X
<b>Financial liability</b>						
Non-current borrowings	X	X	X	X	X	X
Current borrowings	X	X	X	X	X	X
Current portion of non-current borrowings	X	X	X	X	X	X
Finance lease liability	X	X	X	X	X	X
<b>20XX-1</b>	<b>Carrying amount</b>	<b>Average interest rate %</b>	<b>If interest rates were X% higher</b>		<b>If interest rates were X% lower</b>	
			<b>Net profit</b>	<b>Equity</b>	<b>Net profit</b>	<b>Equity</b>
<b>Financial assets</b>						
Trade receivables	X	X	X	X	X	X
Other financial assets at fair value through profit and loss	X	X	X	X	X	X
Cash and cash equivalents	X	X	X	X	X	X
<b>Financial liability</b>						
Non-current borrowings	X	X	X	X	X	X
Current borrowings	X	X	X	X	X	X
Current portion of non-current borrowings	X	X	X	X	X	X
Finance lease liability	X	X	X	X	X	X

**Other market risk disclosures** may also be necessary to fully inform financial statement users. When the sensitivity analyses are unrepresentative of a risk inherent in a financial instrument (e.g., because the year-end exposure does not reflect the actual exposure during the year), the entity is to disclose that fact, together with the reason it believes the sensitivity analyses are unrepresentative.

**Disclosure example: Foreign currency risk and equity price risk disclosures:**

**Foreign currency risk**

Foreign currency risk refers to the risk that the value of a financial commitment or recognized asset or liability will fluctuate due to changes in foreign currency rates. The

group is exposed to foreign currency risk as a result of future transactions, foreign borrowings, and investments in foreign companies, denominated in Euros.

The group makes use of forward exchange contracts to manage the risk relating to future transactions, in accordance with its risk management policy. The fair value of the forward exchange contracts was £X (20XX-1: £X). Gains on the forward exchange contracts were £X (20XX-1: £X). The future transactions related to the forward exchange contracts are expected to occur within the next three months. No amounts were recognized directly in equity during the period or the prior period as the relationship between the forward exchange contracts and the item being hedged does not meet certain conditions in order to qualify as a hedging relationship. Changes in the fair values of forward exchange contracts are recognized directly in profit or loss.

The group foreign currency risk exposure from recognized assets and liabilities arises primarily from non-current foreign borrowings (note XX) and investments in foreign companies (note XX) denominated in Euros. The group manages the exchange risk on translation of investments in foreign companies with borrowings denominated in the same currency. There is no significant impact on profit or loss from foreign currency movements associated with these assets and liabilities as the effective portion of foreign currency gains or losses arising are recorded through the translation reserve. The net gain of £X (20XX-1: £X) in the translation reserve takes into account the related hedges. The ineffective portion of the gain or loss is recognized in profit or loss and amounted to £X (20XX-1: £X).

Foreign currency risk sensitivity analysis:

	Profit/loss		Equity	
	20XX	20XX-1	20XX	20XX-1
If there was an X% weakening in the Sterling/Euro exchange rate with all other variables held constant - increase/(decrease)	x	x	x	x
If there was an X% strengthening in the Sterling/Euro exchange rate with all other variables held constant - increase/(decrease)	x	x	x	x

The impact of a change of X% has been selected as this is considered reasonable given the current level of exchange rates and the volatility observed both on a historical basis and market expectations for future movement. When applied to the Sterling/Euro exchange rate this would result in a weakened exchange rate of X and a strengthened exchange rate of X. This range is considered reasonable given the historic changes that have been observed. For example over the last five years, the Sterling exchange rate against the Euro has traded in the range X to X. The group's sensitivity to exchange rates has not changed significantly from the prior year.

#### Equity price risk

Investments by the group in available-for-sale financial assets expose the group to equity price risk. This risk is managed by diversifying the group's investment portfolio. There is no impact on profit or loss until the investments are disposed of as fluctuations in fair value for the year of £X (20XX-1: £X) are recorded directly in the fair value reserve. Fluctuations in the fair value of investments are not hedged

Equity price risk sensitivity analysis:

	Profit/loss		Equity	
	20XX	20XX-1	20XX	20XX-1
If there was an X% decrease in equity prices with all other variables held constant - increase/(decrease)	x	x	x	x
If there was an X% increase in equity prices with all other variables held constant - increase/(decrease)	x	x	x	x

The impact of a change of X% has been selected as this is considered reasonable given the current level of volatility observed both on a historical basis and market expectations for future movement. The range in equity prices is considered reasonable given the historic changes that have been observed. The group's sensitivity to equity prices has not changed significantly from the prior year.

## DISCLOSURES ON OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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The latest amendments to IFRS 7 effective January 1, 2013 require entities to disclose information about rights of offset and related arrangements for financial instruments under an enforceable master netting agreement or similar arrangements irrespective of whether they are offset in the statement of financial position.

The entity shall disclose the information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position. This includes the effect or potential effect of rights of set off associated with the entity's recognized financial assets and recognized financial liabilities. Some of the quantitative disclosures required are:

- a. Gross amounts of those recognized financial assets and recognized financial liabilities;
- b. Amount that are set off in accordance with the criteria in paragraph 42 of IAS 32 when determining the net amounts presented in the statement of financial position;
- c. Net amounts presented in the statement of financial position;
- d. The amounts subject to enforceable master netting arrangement or a similar agreement that are not otherwise included in paragraph 13c(b) including:
  - a. Amounts related to recognized financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of IAS 32;
  - b. Amounts related to financial collateral (including cash collateral);
- e. The net amount after deducting the amounts in (d) from the amounts in (c) above.

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*NOTE: It is worth noting that the standard suggests that the above disclosure is to be presented in a tabular format, separately for financial assets and financial liabilities, unless another format is appropriate.*

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The total amount disclosed in accordance in (d) above for an instrument shall be limited to the amount in (c) above for that same instrument. This means that if the amount in (c) is a net financial liability the deducting amount in (d) will not result to being disclosed as an asset.

The entity shall include a description in the disclosures of the rights of set off associated with the entity's recognized financial assets and recognized financial liabilities subject to enforceable master netting arrangement and similar agreement that are disclosed in accordance with (d) above, including the nature of those rights.

IFRS 7 paragraph 13E suggests that where disclosures have been made in more than one note, the entity shall cross refer between the notes.

Illustrative example as below:

### **FINANCIAL ASSETS TO OFFSETTING, ENFORCEABLE MASTER NETTING ARRANGEMENTS AND SIMILAR AGREEMENTS**

Description	(a) Gross amounts of recognized financial assets	(b) Gross amounts of recognized financial liabilities set off in the statement of financial position	(c)=(a)-(b) Net amounts of financial assets presented in the statement of financial position	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d) Net amount
				(d) (i), (d) (ii) Financial instruments	(d) (ii) Cash collateral received	
Derivatives	xx	(xx)	xx	(xx)	(xx)	xx
Reverse repurchase, securities borrowing and similar agreements	xx	-	xx	(xx)	-	-
Other financial instruments	-	-	-	-	-	-
Total	xx	(xx)	xx	(xx)	(xx)	xx

**FINANCIAL LIABILITIES SUBJECT TO OFFSETTING, ENFORCEABLE  
MASTER NETTING ARRANGEMENTS AND SIMILAR AGREEMENTS**

Description	(a) Gross amounts of recognized financial assets	(b) Gross amounts of recognized financial assets set off in the statement of financial position	(c)=(a)-(b) Net amounts of financial liabilities presented in the statement of financial position	(d) Related amounts not set off in the statement of financial position		(e) = (c)-(d) Net amount
				(d) (i), (d) (ii) Financial instruments	(d) (ii) Cash collateral pledged	
Derivatives	xx	(xx)	xx	(xx)	(xx)	-
Reverse repurchase, securities lending and similar agreements	xx	-	xx	(xx)	-	-
Other financial instruments	-	-	-	-	-	-
Total	xx	(xx)	xx	(xx)	-	-

**FINANCIAL ASSETS SUBJECT TO OFFSETTING, ENFORCEABLE  
MASTER NETTING ARRANGEMENTS AND SIMILAR AGREEMENTS**

Description	(a) Gross amounts of recognized financial assets	(b) Gross amounts of recognized financial liabilities set off in the statement of financial position	(c)=(a)-(b) Net amounts of financial assets presented in the statement of financial position
Derivatives	xx	(xx)	xx
Reverse repurchase, securities borrowings and similar agreements	xx	-	xx
Other financial instruments	-	-	-
Total	xx	(xx)	xx

**NET FINANCIAL ASSETS SUBJECT TO ENFORCEABLE MASTER NETTING ARRANGEMENTS AND SIMILAR AGREEMENTS, BY COUNTERPARTY**

Description	(c) Net amounts of financial assets presented in the statement of financial position	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d) Net amounts
		(d) (i), (d) (ii) Financial instruments	(d) (ii) Cash collateral received	
Counterparty A	xx	-	(xx)	xx
Counterparty B	xx	(xx)	(xx)	-
Counterparty C	xx	(xx)	-	-
Other	-	-	-	-
Total	xx	(xx)	(xx)	xx

Illustrative disclosures under IFRS 7.

**NOTES TO FINANCIAL STATEMENTS**

**2. Accounting policies**

**2.8 Financial instruments**

The group classifies financial instruments, or their component parts, on initial recognition as a financial asset, a financial liability or an equity instrument in accordance with the substance of the contractual arrangement. Financial instruments are recognized when the group becomes a party to the contractual provisions of the instrument.

Financial instruments are recognized initially at fair value plus transactions costs that are directly attributable to the acquisition or issue of the financial instrument, except for financial assets at fair value through profit or loss, which are initially measured at fair value, excluding transaction costs (which is recognized in profit or loss).

Equity instruments, for which fair value is not determinable, are measured at cost and are classified as available-for-sale financial assets.

Financial assets are derecognized when the rights to receive cash flows from the investments have expired or have been transferred and the group has transferred substantially all risk and rewards of ownership.

**2.8.1 Available-for-sale financial assets**

Available-for-sale financial assets comprise equity investments. Subsequent to initial recognition available-for-sale financial assets are stated at fair value. Movements in fair

values are taken directly to equity, with the exception of impairment losses and foreign exchange gains or losses which are recognized in profit or loss. Fair values are based on prices quoted in an active market if such a market is available. If an active market is not available, the group establishes the fair value of financial instruments by using a valuation technique, usually discounted cash flow analysis. When an investment is disposed, any cumulative gains and losses previously recognized in equity are recognized in profit or loss. Dividends are recognized in profit or loss when the right to receive payments is established.

### *2.8.2 Financial assets at fair value through profit and loss*

Financial assets at fair value through profit and loss include financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. A financial asset is classified in this category if acquired principally for the purpose of selling or repurchasing in the short term. Financial assets at fair value through profit and loss comprise derivative financial instruments, namely interest rate swaps and forward exchange contracts. Subsequent to initial recognition financial assets at fair value through profit and loss are stated at fair value. Movements in fair values are recognized in profit or loss, unless they relate to derivatives designated and effective as hedging instruments, in which event the timing of the recognition in profit or loss depends on the nature of the hedging relationship. The group designates certain derivatives as hedging instruments in fair value hedges of recognized assets and liabilities and firm commitments, and in cash flow hedges of highly probable forecast transactions and foreign currency risks relating to firm commitments.

The effective portion of fluctuations in the fair value of interest rate swaps used to hedge interest rate risk and that qualify as fair value hedges are recognized together with finance costs. The ineffective portion of the gain or loss is recognized in other expenses or other income.

Fluctuations in the fair value of forward exchange contracts used to hedge currency risk of future cash flows, and the fair value of foreign currency monetary items on the statement of financial position, are recognized directly in other expenses or other income. This policy has been adopted as the relationship between the forward exchange contracts and the item being hedged does not meet certain conditions in order to qualify as a hedging relationship.

### *2.8.3 Trade receivables*

Trade receivables are measured at initial recognition at fair value, and are subsequently measured at amortized cost using the effective interest rate method, less provision for impairment. Trade receivables are reduced by appropriate allowances for estimated irrecoverable amounts. Interest on overdue trade receivables is recognized as it accrues.

### *2.8.4 Cash and cash equivalents*

Cash equivalents comprise short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. An investment with a maturity of three months or less is normally classified as being short-term. Bank overdrafts are shown within borrowing in current liabilities.

### *2.8.5 Trade payables*

Trade payables are initially measured at fair value, and subsequently measured at amortized cost using the effective interest rate method.

### 2.8.6 Bank overdrafts and interest-bearing borrowings

Bank overdrafts and interest-bearing borrowings are recognized initially at fair value, net of transaction costs incurred and subsequently measured at amortized cost using the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability.

### 2.8.7 Equity instruments

Equity instruments issued by the group are recorded at the value of proceeds received, net of costs directly attributable to the issue of the instruments.

### 2.8.8 Compound instruments

At the issue date the fair value of the liability component of a compound instrument is estimated using the market interest rate for a similar non-convertible instrument. This amount is recorded as a liability at amortized cost using the effective interest method until extinguished upon conversion or at the instrument redemption date. The equity component is determined as the difference of the amount of the liability component from the fair value of the instrument. This is recognized in equity, net of income tax effects, and is not subsequently remeasured.

### 2.8.9 Net investment in foreign operation

The effective portion of fluctuations in the fair value of the hedging instrument used to hedge currency risk of net investments in foreign companies is recognized directly in equity. The ineffective portion of the gain or loss is recognized in profit or loss. The gain or loss deferred in equity, or part thereof, for hedges of net investments in foreign companies is recycled through profit or loss when the interest in or part of the interest in, the foreign company is disposed of.

### 2.8.10 Impairment of financial assets

All financial assets measured at amortized cost are assessed for indicators of impairment at each reporting date.

### 2.8.11 Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or to realize the asset and settle the liability simultaneously.

## 7. Gains and losses in respect of financial instruments

	20XX	20XX- 1
Net gains on other financial assets at fair value through profit and loss	X	X
Gain/(Loss) on disposal of available-for-sale investments transferred from equity	X	X
Impairment of trade receivables	X	X



Impairment of available-for-sale investments	X	X
Ineffectiveness arising from cash flow hedges	X	X
Ineffectiveness arising from hedges of net investments	X	X

### 3.8 Financial instruments and financial risk management

#### 3.8.1 Categories of financial instruments

20XX				
Assets as per balance sheet	Loans and receivables	Assets at fair value through profit or loss	Derivatives used for hedging	Available-for-sale
Available-for-sale investments				X
Trade receivable	X			
Other current assets at fair value through profit or loss		X	X	
Cash and cash equivalents	X			
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Liabilities as per balance sheet	Loans and receivables	Financial liabilities measured at amortized cost	Derivatives used for hedging	
Non-current borrowings		X		
Current borrowings		X		
Current portion of non-current borrowings		X		
Finance lease liability		X		
<b>Total</b>	<b>-</b>	<b>X</b>		<b>-</b>
20XX-1				
Assets as per balance sheet	Loans and receivables	Assets at fair value through profit or loss	Derivatives used for hedging	Available-for-sale
Available-for-sale investments				X
Trade receivable	X			
Other current assets at fair value through profit or loss		X	X	
Cash and cash equivalents	X			
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Liabilities as per balance sheet	Loans and receivables	Financial liabilities measured at amortized cost	Derivatives used for hedging	
Non-current borrowings		X		
Current borrowings		X		
Current portion of non-current borrowings		X		
Finance lease liability		X		
<b>Total</b>	<b>-</b>	<b>X</b>		<b>-</b>

### 3.8.2 Classes and fair value of financial instruments

Below is a comparison of the carrying value and the fair value of the group's financial instruments, other than those with a carrying value that approximates its fair value.

	20XX		20XX-1	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Financial assets</b>				
Available-for-sale investments	X	X	X	X
Other current assets	X	X	X	X
Other current assets at fair value through profit or loss	X	X	X	X
Cash and cash equivalents	X	X	X	X
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
<b>Financial liabilities</b>				
Non-current borrowings	X	X	X	X
Current borrowings/Trade payables	X	X	X	X
Current portion of non-current borrowings	X	X	X	X
Finance lease liability	X	X	X	X
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>

It is the directors' opinion that the carrying value of trade receivables and trade payables approximates their fair value due to the short-term maturities of these instruments.

### 3.8.3 Fair value hierarchy and measurements

#### 3.8.3.1 Financial assets and liabilities that are measured at fair value on a recurring basis

	Fair value measurement as at 31 December 20XX			
	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Financial assets at fair value through profit or loss</b>				
Trading derivatives	X	X	X	X
Trading securities	X	X	X	X
<b>Derivatives used for hedging</b>				
Interest rate contracts	X	X	X	X
<b>Available-for-sale financial assets</b>				
Available-for-sale investments	X	X	X	X
	Fair value measurement as at 31 December 20XX-1			
	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Financial assets at fair value through profit or loss</b>				
Trading derivatives	X	X	X	X
Trading securities	X	X	X	X
<b>Derivatives used for hedging</b>				
Interest rate contracts	X	X	X	X
<b>Available-for-sale financial assets</b>				
Available-for-sale investments	X	X	X	X

**Level 1** The fair value of financial instruments traded in an active market is based on quoted market prices at the reporting date. The quoted market price used for financial assets held by the group is the quoted bid price.

**Level 2** The fair value of financial instruments not traded in an active market is determined by using valuation techniques. Specific valuation techniques used to value the above financial instruments include:

- Discounted cash flow analysis using rates currently available for debt on similar terms, credit risk and remaining maturity.
- Quoted market prices for similar instruments.
- Price earnings multiple model.

If all significant inputs in the valuation technique used are observable, the instrument is included in level 2, if not the instrument is included in level 3.

**Level 3** Included in level 3 are holdings in unlisted shares which are measured at fair value, using the price earnings multiple model. The key assumption used by management is a price-earnings multiple of X (20XX-1: X) which is not observable from market or related data. Management consider a reasonable possible alternative assumption would result in a decrease/increase of X (20XX-1: decrease/increase of Y) in the value of unlisted investments. This sensitivity represents a change in the price earnings multiple of 10%.

The following table presents the changes in level 3 instruments.

	<b>Financial assets at fair value through profit or loss</b>	<b>Derivatives used for hedging</b>	<b>Available- for-sale financial assets</b>	<b>Total</b>
Opening balance 1 January 20XX	X	X	X	<b>X</b>
Total gains or losses				
In profit or loss	X	X	X	<b>X</b>
In other comprehensive income	X	X	X	<b>X</b>
Purchases	X	X	X	<b>X</b>
Issues	X	X	X	<b>X</b>
Settlements	X	X	X	<b>X</b>
Transfers out of level 3	X	X	X	<b>X</b>
<b>Closing balance 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	X	X	X	<b>X</b>
Change in unrealized gains or losses for the period included in profit or loss for assets held at the end of the reporting period	X	X	X	<b>X</b>

	Financial assets at fair value through profit or loss	Derivatives used for hedging	Available- for-sale financial assets	Total
Opening balance 1 January 20XX-1	X	X	X	X
Total gains or losses				
In profit or loss	X	X	X	X
In other comprehensive income	X	X	X	X
Purchases	X	X	X	X
Issues	X	X	X	X
Settlements	X	X	X	X
Transfers out of level 3	X	X	X	X
<b>Closing balance 31 December 20XX-1</b>	X	X	X	X
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	X	X	X	X
Change in unrealized gains or losses for the period included in profit or loss for assets held at the end of the reporting period	X	X	X	X

### 3.8.3.2 Financial assets and liabilities that are not measured at fair value on a recurring basis

	Fair value measurement as at 31 December 20XX			
	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Trade and other receivables	-	X	-	X
Cash and cash equivalents	X	-	-	X
<b>Financial liabilities</b>				
<b>Financial liabilities held at amortized costs</b>				
Bank loans	-	-	X	X
Loans from other entities	-	-	X	X
Trade and other payables	-	X	-	X
Finance lease payables	-	X	-	X
	Fair value measurement as at 31 December 20XX-1			
	Level 1	Level 2	Level 3	Total
<b>Financial assets</b>				
<b>Loans and receivables</b>				
Trade and other receivables	-	X	-	X
Cash and cash equivalents	X	-	-	X
<b>Financial liabilities</b>				
<b>Financial liabilities held at amortized costs</b>				
Bank loans	-	-	X	X
Loans from other entities	-	-	X	X
Trade and other payables	-	X	-	X
Finance lease payables	-	X	-	X

### 3.8.3.2 *Financial assets and liabilities that are not measured at fair value on a recurring basis*

The fair values of the financial assets and liabilities disclosed under level 2 and 3 above have been determined in accordance with generally accepted pricing models based on a discounted cash flow analysis, with the most significant inputs being the discount rate.

## US GAAP COMPARISON

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The guidance for financial instruments for both US GAAP and IFRS is undergoing significant changes as a result of a study issued by the Financial Crisis Advisory Group (FCAG) after the 2008 financial crises.

Currently effective US GAAP and IFRS guidance contains many similarities, but also many differences, particularly with regard to hedging. Both standards segregate financial instruments into held-to-maturity, available-for-sale and trading. Similar to IFRS, held-to-maturity assets are maintained at amortized costs. Available-for-sale instruments are marked to market with changes offset to other comprehensive income. Trading instruments are marked to fair value and reflected in profit and loss.

Differences include:

- US GAAP permits the fair value option for equity method investments.
- US GAAP does not allow designation of a financial instrument through profit and loss. Presentation in profit and loss or other comprehensive income is determined by the classification as trading or available-for-sale.
- The hedging of a portfolio of assets and liabilities is much more difficult to achieve under US GAAP. Instruments must be almost perfectly correlated. US GAAP allows a “short-cut” method for hedging of interest rates when specific conditions are met. This allows simpler testing to prove effectiveness of a hedge. There is no specified range of loss or gain offset to determine hedge effectiveness for a decision on whether hedge accounting is still permitted (IFRS employs a range of 80% to 125%). Also, guidance of documentation of hedging strategy is more prescriptive.
- Impairments of financial instruments cannot be reversed under US GAAP. The reduced carrying amount of the investment becomes that investment’s new cost basis. This new cost basis is not changed for any subsequent recoveries in fair value. Unrealized gains and losses from changes in the fair value of available-for-sale securities are recorded in an unrealized gain or loss account in other comprehensive income. Subsequent recoveries in the fair value of available-for-sale securities are included in other comprehensive income.
- US GAAP contains more detailed guidance as to when a transfer of a financial instrument is a sale rather than a financing.
- US GAAP does not permit reclassification from the trading category.
- US GAAP designates certain instruments with characteristics of both debt and equity that must be classified as liabilities.
- Hybrid financial instruments are only split into debt and equity components if specific conditions are met. However, they may be bifurcated into debt.
- For held-to-maturity investments, the amount of the impairment related to a credit loss is recognized in the income statement, and the remainder is recognized in comprehensive income. This impairment is accreted to the carrying amount of the held-to-maturity investment through other comprehensive income.

- US GAAP permits the shortcut method for interest rate swaps that are used to hedge debt instruments.
- US GAAP permits inclusion of an option's time value when assessing hedge effectiveness.
- US GAAP provides specific guidance for limited liability entities that invest in affordable housing projects.
- US GAAP provides specific guidance for accounting for troubled debt restructurings that invest in government-sponsored loan guarantee programs.

the IASB and FASB have reaffirmed their commitment to the continued use of fair values in financial reporting in appropriate circumstances, while acknowledging the need for more guidance with respect to the determination of fair values.

The majority of investors and creditors that use financial statements for decision-making purposes argue that reporting financial instruments at historical cost or amortized cost deprives them of important information about the economic impact on the reporting entity of real economic gains and losses associated with changes in the fair values of assets and liabilities that it owns or owes. Many assert that, had they been provided timely fair value information, they might well have made different decisions regarding investing in, lending to or entering into business transactions with the reporting entities.

Others, however, argue that transparent reporting of fair values creates “procyclicality,” whereby the reporting of fair values has the effect of directly influencing the economy and potentially causing great harm. These arguments are countered by fair value advocates, who state their belief that the “Lost Decade”—the extended economic malaise that afflicted Japan from 1991 to 2000—was exacerbated by the lack of transparency in its commercial banking system, which allowed its banks to avoid recognizing losses on loans of questionable credit quality and diminished, but concealed, values.

IASB has been on record for many years regarding its long-term goal of having all financial assets and liabilities reported at fair value. That said, it has taken a cautious, incremental approach towards attaining this goal, not unlike the experience of the FASB in setting US GAAP. After addressing a number of matters that had been assigned higher priority, however, IASB dedicated significant attention to the fair value project beginning in 2005, as part of its announced convergence efforts with FASB. It was decided early in this process that FASB’s monumental standard, FAS 157, *Fair Value Measurements* (now codified as ASC 820), issued in 2006, would serve as the basis for IASB’s intended standard. IASB issued a Discussion Paper to that effect in late 2006, followed by an Exposure Draft (ED) in mid-2009.

In June 2011 the IASB completed its project and issued IFRS 13, *Fair Value Measurement*, on which the balance of this chapter is based. IFRS 13 is effective for annual periods beginning on or after January 1, 2013.

<b>Sources of IFRS</b> <i>IFRS 13</i>
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## SCOPE

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IFRS 13, *Fair Value Measurement* applies when another IFRS requires or permits the use of fair value measurements or disclosures about fair value measurements. To that extent the IFRS does not extend the use of fair value measures in financial reporting but does bring about a more cohesive and comprehensive scope within which the concept of fair values is applied. This could be seen as an important building block in the extended use of fair values in the future, although that is not an objective the IASB has stated categorically at this time.

Excluded from the measurement and disclosure scope of the IFRS, however, are some “fair value based” transactions such as:

- Share-based payments within the scope of IFRS 2, *Share-Based Payments*;
- Leasing transactions within the scope of IAS 17, *Leases*;

- And other measurements with similarities to fair value such as net realizable value as it relates to IAS 2, *Inventory*, or value in use in terms of IAS 36, *Impairment of Assets*.

In addition the disclosure requirements of the IFRS do not apply to disclosures relating to:

- Fair value of plan assets in terms of IAS 19, *Employee Benefits*;
- Retirement benefit plan investments in terms of IAS 26, *Accounting and Reporting by Retirement Benefit Plans*;
- Assets for which the recoverable amount is fair value less costs to sell in terms of IAS 36, *Impairment of Assets*.

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*NOTE: The fair value measurement framework described in IFRS 13 applies to both initial and subsequent measurement if fair value is required or permitted by other IFRS.*

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## DEFINITIONS OF TERMS

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**Active market.** A market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

**Cost approach.** A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (sometimes referred to as current replacement cost).

**Entry price.** The price paid to acquire an asset or received to assume a liability in an exchange transaction.

**Exit price.** The price that would be received to sell an asset or paid to transfer a liability.

**Expected cash flow.** The probability-weighted average (i.e., mean of the distribution) of possible future cash flows.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Highest and best use.** The use of a non-financial asset by market participants that would maximize the value of the asset or the group of assets and liabilities (e.g., a business) within which the asset would be used.

**Income approach.** Valuation techniques that convert future amounts (e.g., cash flows or income and expenses) to a single current (i.e., discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

**Inputs.** The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable.

**Level 1 inputs.** Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

**Level 2 inputs.** Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices).

**Level 3 inputs.** Unobservable inputs for the asset or liability.

**Market approach.** A valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities (i.e., a business).



**Market-corroborated inputs.** Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

**Market participants.** Buyers and sellers in the principal (or most advantageous) market for an asset or liability that have all of the following characteristics:

1. Independent of each other, i.e., they are not *related parties* as defined in IAS 24, although the price in a related party transaction may be used as an input to a fair value measurement if the entity has evidence that the transaction was entered into a market term.
2. Knowledgeable and have a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
3. Able to enter into a transaction for the asset or liability.
4. Willing to enter into a transaction for the asset or liability (i.e., they are not under duress that would force or compel them to enter into the transaction).

**Most advantageous market.** The market that maximizes the amount that would be received from the sale of the asset or that minimizes the amount that would be paid to transfer the liability, after consideration of transaction and transport costs. (Although transaction costs are considered in making a determination of the market that is most advantageous, such costs are not to be factored into the fair value valuation determined by reference to that market).

**Non-performance risk.** The risk that the entity will not fulfill an obligation. This includes, but is not limited to, the entity's own credit risk.

**Observable inputs.** Inputs that are developed on the basis of available market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

**Orderly transaction.** A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g., a forced liquidation or distress sale).

**Principal market.** The market with the greatest volume and level of activity for the asset or the liability.

**Risk premium.** Compensation sought by risk-averse market participants for bearing the uncertainty inherent in the cash flows of an asset or a liability, sometimes referred to as a "risk adjustment."

**Transaction costs.** The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and result directly from and are essential to the transaction, and would not have been incurred had the transaction not occurred (similar to the "costs to sell" in terms of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*).

**Transport costs.** The costs that would be incurred to transport an asset from its current location to its principal or most advantageous market.

**Unit of account.** The level at which an asset or liability is aggregated or disaggregated in an IFRS for recognition purposes.

**Unobservable inputs.** Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

## **FAIR VALUE MEASUREMENT PRINCIPLES AND METHODOLOGIES**

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In its objectives the IFRS clearly sets out that fair value is a market-based measurement and not an entity specific measurement. This premise permeates the entire approach to the determination of fair value for assets and liabilities, and makes the asset or the liability and the related markets the center of the approach and not the entity's circumstances at the measurement date. Consequently fair value is based on the presumption of an orderly transaction between market participants (as defined) at measurement date under current market conditions, from the perspective of a market participant that holds the asset or owes the liability, in other words it is an exit price.

To the extent possible, fair value should be based on an observable price. However, in many instances such a price may not be available and the determination of fair value will rely on the use of valuation techniques. Such valuation techniques should have a strong bias towards the use of observable rather than unobservable inputs, as these are considered more objective and more likely to be taken into consideration by market participants than unobservable inputs.

Although the IFRS has a focus on assets and liabilities, the requirements of the IFRS are equally applicable to the determination of the fair value of an entity's own equity instrument, where required.

IASB has explicitly addressed the logic of requiring an exit price definition. It has stated that it is the exit price of an asset or liability that embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of market participants at the measurement date. Since an entity generates cash inflows from an asset either by using it or by selling it, even if an entity intends to generate cash inflows from an asset by using it rather than by selling it, an exit price embodies expectations of the cash flows that would arise for a market participant holding the asset. For this reason, IASB concluded that an exit price is always a relevant definition of fair value for assets, regardless of whether an entity intends to use an asset or to sell it.

For a similar reason, IASB found that a liability gives rise to outflows of cash (or other economic resources) as an entity fulfills the liability over time or when it transfers the liability to another party. Even if an entity intends to fulfill the liability over time, an exit price embodies expectations about cash outflows because a market participant transferee would ultimately be required to fulfill the liability. Accordingly, IASB concluded that an exit price is always a relevant definition of fair value for liabilities, regardless of whether an entity intends to fulfill the liability over time or to transfer it to another party that will fulfill it over time.

The level at which this IFRS is to be applied is determined by the unit of account in terms of the relevant IFRS that requires or permits the use of fair value in the first instance, and therefore the level of application is not specifically addressed by this IFRS unless otherwise specified.

It is helpful to break down the measurement process of determining fair value measurement into a series of steps. Although not necessarily performed in a linear manner, the following procedures and decisions need to be applied and made, in order to value an asset or liability at fair value. Each of the steps will be discussed in greater detail.

1. *Identify the item to be valued and the unit of account.* Identify the asset or liability, including the unit of account to be used for the measurement. One needs to refer to other IFRS for directions regarding unit of account, since the proposed standard on fair value measurement does not provide these.

2. *Determine the most advantageous market and the relevant market participants.* From the reporting entity's perspective, determine the most advantageous market in which it would sell the asset or transfer the liability. In the absence of evidence to the contrary, the most advantageous market can be considered to be the principal market for the asset or the liability, which is the market with the greatest volume of transactions and level of activity. Once the most advantageous market is identified, determine the characteristics of the market participants. It is not necessary that specifically named individuals or enterprises be identified for this purpose.
3. *Select the valuation premise to be used for asset measurements.* If the item being measured is a non-financial asset, determine the valuation premise to be used by evaluating how market participants would apply the "highest and best use," for example, considering the value of the asset on a stand-alone basis or its fair value in conjunction with other related assets and liabilities.
4. *Consider the risk assumptions applicable to liability measurements.* If the item being measured is a liability, identify the key assumptions that market participants would make regarding non-performance risk including, but not limited to, the reporting entity's own credit risk (credit standing).
5. *Identify available inputs.* Identify the key assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. In identifying these assumptions, referred to as "inputs," maximize the inputs that are relevant and observable (i.e., that are based on market data available from sources independent of the reporting entity). In so doing, assess the availability of relevant, reliable market data for each input that significantly affects the valuation, and identify the level of the new fair value input hierarchy in which it is to be categorized.
6. *Select the appropriate valuation technique(s).* Based on the nature of the asset or liability being valued, and the types and reliability of inputs available, determine the appropriate valuation technique or combination of techniques to use in valuing the asset or liability. The three broad categories of techniques are the market approach, the income approach and the cost approach.
7. *Make the measurement.* Measure the asset or liability.
8. *Determine amounts to be recognized and information to be disclosed.* Determine the amounts and information to be recorded, classified, and disclosed in interim and annual financial statements.

#### ***Item identification and unit of account***

In general, the same unit of account at which the asset or liability is aggregated or disaggregated by applying other applicable IFRS pronouncements is to be used for fair value measurement purposes. The asset or liability measured at fair value might be either a stand-alone asset or liability (e.g., a financial instrument or a non-financial asset) or a group of assets, a group of liabilities or a group of assets and liabilities (e.g., a cash-generating unit or a business). No adjustment may be made to the valuation for a "blockage factor." A blockage factor is an adjustment made to a valuation that takes into account the fact that the investor holds a large quantity (block) of shares relative to the market trading volume in those shares. The prohibition applies even if the quantity held by the reporting entity exceeds the market's normal trading volume—and that, if the reporting entity were, hypothetically, to place an order to sell its entire position in a single transaction, that transaction could affect the quoted price.

### *The principal or most advantageous market*

The IFRS requires the entity performing the valuation to maximize the use of relevant assumptions (inputs) that are observable from market data obtained from sources independent of the reporting entity. In making a fair value measurement, management is to assume that the asset or liability is exchanged in a hypothetical, orderly transaction between market participants at the measurement date.

To characterize the exchange as orderly, it is assumed that the asset or liability will have been exposed to the market for a sufficient period of time prior to the measurement date to enable marketing activities to occur that are usual and customary with respect to transactions involving such assets or liabilities. It is also to be assumed that the transaction is not a forced transaction (e.g., a forced liquidation or distress sale).

The fair value is to be measured by reference to the principal market, or in the absence of a principal market, the most advantageous market. Unless otherwise apparent it is assumed that the principal market is the market in which the entity would normally transact to sell the asset or transfer the liability. An entity, therefore, need not engage in elaborate efforts to identify the principal market. This approach is deemed appropriate and broadly consistent with the concept of the most advantageous market, as it is reasonable that an entity would normally transact in the most advantageous market to which it has access, taking into consideration *transaction and transport costs*.

Note that the determination of the most advantageous market is made from the perspective of the reporting entity, as the reporting entity needs to have access to the principal market. Thus, different reporting entities engaging in different specialized industries, or with access to different markets, might not have the same most advantageous market for an identical asset or liability. The IFRS provides a typology of markets that potentially exist for assets or liabilities.

1. *Exchange markets.* A market in which closing prices are readily available and generally representative of fair value. Examples of such markets include NYSE, Euronext, Toronto Stock Exchange, London Stock Exchange, Hong Kong Stock Exchange and Johannesburg Securities Exchange amongst others.
2. *Dealer markets.* A market in which parties (dealers referred to as market makers) stand ready to buy or sell a particular investment for their own account at bid and ask prices that they quote. The bid price is the price the dealer is willing to pay to purchase the investment and the ask price is the price at which the dealer is willing to sell the investment. In these markets, these bid and ask prices are typically more readily available than are closing prices characteristic of active exchange markets. By using their own capital to finance and hold an inventory of the items for which they “make a market,” these dealers provide the market with liquidity. Dealer markets include over-the-counter markets for which the prices at which transactions have been concluded could be publicly available. Dealer markets exist for financial instruments and non-financial assets such as commodities, equipment and such items.
3. *Brokered market.* These markets use “brokers” or intermediaries to match buyers with sellers. Brokers do not trade for their own account and do not hold an inventory in the security. The broker knows the bid and asked prices of the potential counterparties to the transaction but the counterparties are unaware of each other’s price requirements. Prices of consummated transactions are sometimes available privately or as a matter of public record. Brokered markets include electronic communication

networks that match buy and sell orders, as well as commercial and residential real estate markets. In some cases, each of the counterparties is aware of the other's identity, while in other cases, their identities are not disclosed by the broker.

4. *Principal-to-principal market.* A market in which the counterparties negotiate directly and independently without an intermediary. Because no intermediary or exchange is involved, little if any information about these transactions is released to the public.

**Example: Principal or most advantageous market (IFRS 13.IE19-22)**

An asset is sold in two different active markets at different prices. An entity enters in transactions in both markets and can access the price in those markets for the asset at the measurement date.

	Market A	Market B
Price	€26	€25
Transaction Costs	€3	€1
<u>Transportation Costs</u>	<u>€2</u>	<u>€2</u>
Net Amount	€21	€22

If Market A is the principal market for the asset (the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price in Market A less transportation costs (€24).

If neither market is the principal market for the asset, the fair value would be measured using the price in the most advantageous market. The most advantageous market is the market that maximizes the net amount that would be received to sell the asset after deducting transactions costs and transportation costs from the gross amount.

In the case above this would be Market B, the fair value of the asset would be €23 (price €25 less transportation costs of €2). Although the transactions costs are taken into account when determining the most advantageous market, the price used to measure the fair value is not adjusted for these costs.

### **Market participants**

Fair value will be measured using the assumptions that a market participant would take into consideration assuming that the market participant would behave in his best economic interests. It is not necessary for an entity to identify an actual market participant for this purpose as this is a hypothetical construct. Instead the entity will develop a "picture" of the market participant by taking into consideration factors such as the nature of the asset or liability, the principal (or most advantageous) market and the market participants with whom the entity would enter into a transaction in that market. In light of the market-oriented alignment, company-specific assumptions are therefore irrelevant, and the valuation must be based on premises that typical market participants would assume when defining a price in their own commercial interests. As such, the consideration of factors whose impacts would be assessed differently by a typical market participant is crucial, and therefore the company-specific circumstances and assumptions of the reporting company are not decisive.

The hypothetical market participants can be summarized as:

1. Independent of each other (i.e., are unrelated third parties).
2. Knowledgeable (i.e., are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability).

3. Able to enter into a transaction for the asset or liability.
4. Willing to enter into a transaction for the asset or liability (i.e., they are motivated but not forced or otherwise compelled to do so).

**Measurement considerations when transactions are not orderly.** In recent years, there have been heightened concerns about the effects of tumultuous or illiquid credit markets in the US and abroad. The previously active markets for certain types of securities have become illiquid or less liquid. Questions have arisen regarding whether transactions occurring in less liquid markets with less frequent trades might cause those market transactions to be considered forced or distress sales, thus rendering valuations made using those prices not indicative of the actual fair value of the securities.

The presence of the following factors may indicate that a quoted price is not obtained from a transaction that could be considered orderly and therefore may not be indicative of fair value:

1. There has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or for similar assets or liabilities).
2. There have been few recent transactions.
3. Price quotations are not based on current information about the fair value of an asset or liability.
4. Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value of that asset or liability.
5. There has been a significant increase in implied liquidity risk premiums, yields or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.
6. There has been a wide bid-ask spread or significant increase in the bid-ask spread.
7. There has been a significant decline or absence of a market for new issues (i.e., in the primary market) for the asset or liability (or similar assets or liabilities).
8. Little information has been released publicly (e.g., as occurs in a principal-to-principal market).

An entity should evaluate the significance and relevance of the foregoing indicators (together with other pertinent factors) to determine whether, on the basis of the evidence available, a market is not active. If it concludes that a market is not active, it may then also deduce that transactions or quoted prices in that market are not determinative of fair value (e.g., because there may be transactions that are not orderly). Further analysis of the transactions or quoted prices may therefore be needed, and a significant adjustment to the transactions or quoted prices may be necessary to measure fair value.

The IFRS does not prescribe a methodology for making significant adjustments to transactions or quoted prices in such circumstances, however the typology of valuation techniques—the market, income and cost approaches, respectively—apply to these situations equally. Regardless of the valuation technique used, an entity must include any appropriate risk adjustments, including a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) inherent in the cash flows of

an asset or liability. Absent this, the measurement would not faithfully represent fair value. The risk premium should be reflective of an orderly transaction between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. When weighting indications of fair value resulting from the use of multiple valuation techniques (market, income or cost approach), an entity shall consider the reasonableness of the range of fair value measurements. The objective is to determine the point within the range that is most representative of fair value under current market conditions.

**Example: Measuring fair value when there has been a significant decrease in the volume or level of activity (IFRS 13.IE49-58)**

Entity A invests in a junior AAA-rated tranche of a residential mortgage-backed security on 1 January 20X7 (the issue date of the security). The junior tranche is the second most senior of a total of six tranches. The underlying collateral for the residential mortgage-backed security is unguaranteed non-conforming residential mortgage loans that were issued in the second half of 20X5.

At 31 March 20X8 (measurement date) the junior tranche is now A-rated. This tranche of the residential mortgage-backed securities was previously traded through a brokered market. However trading volume was infrequent with only a few transactions taking place per month, so Entity A concludes that the volume and level of activity of the junior tranche have significantly decreased. As there is not enough trading activity to support using a market approach, Entity A decides to use an income approach using the discount rate adjustment technique (IFRS 13.B18-IFRS 13.B22). Entity A uses the contractual cash flows from the residential mortgage-backed security and then estimates a discount rate to discount those contractual cash flows.

Entity A estimates that one indication of the market rate of return that market-participants would use is 12 per cent (1.200 basis points), which was estimated as follows:

- 300 basis points: relevant risk free rate of interest at Measurement Date
- + 250 basis points; credit spread over the risk free rate when the junior tranche was issued
- + 700 basis points: change in credit spread over the risk free rate of the junior tranche between 1 January 20X7 and the measurement date. This estimate was developed on the basis of the change in the most comparable index available for that time period.
- – 350 basis points adjustment to the index used before. This was estimated by comparing the implied yield from the most recent transactions for the residential mortgage-backed security in June 20X7 with the implied yield in the index price in those same dates.
- + 300 basis points adjustment as best estimation for the additional liquidity risk inherent in its security (a cash position) when compared with the index (a synthetic position). This estimate was derived after taking into account liquidity risk premiums implied in recent cash transactions for a range of similar securities.

As an additional indication of the market rate of return, Entity A takes into account two recent indicative quotes (i.e. non-binding quotes) provided by reputable brokers for the junior tranche of the residential mortgage backed-security that imply yields of 15–17 per cent. Entity A is unable to evaluate the valuation technique(s) or inputs used to develop the quotes. However, Entity A is able to confirm that the quotes do not reflect the results of transactions.

Entity A concludes that 13 per cent is the point within the range of indications that is most representative of fair value under current market conditions. Entity A places more weight on the 12 per cent indication as it concludes that its own estimate appropriately incorporated the risks that market participants would use when pricing the asset and the broker quotes were non-binding and did not reflect the results of transactions.

Of utmost importance, even when a market is not active, the objective of a fair value measurement remains the same—to identify the price that would be received to sell an asset or paid to transfer a liability in a transaction that is orderly and not a forced liquidation or distress sale, between market participants at the measurement date under current market conditions. Thereby is an entity's intention to hold the asset or to settle or otherwise fulfill the liability not relevant when measuring fair value, because fair value is a market-based measurement and not an entity-specific measurement.

Even if a market is not active, it would be inappropriate to conclude that all transactions in that market are not orderly (i.e., that they are forced or distress sales). Circumstances that may suggest that a transaction is not orderly, however, include, *inter alia*, the following:

1. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.
2. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.
3. The seller is in or near bankruptcy or receivership (i.e., distressed) or the seller was required to sell to meet regulatory or legal requirements (i.e., forced).
4. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

The reporting entity is required to evaluate the circumstances to determine, based on the weight of the evidence then available, whether the transaction is orderly. If it indicates that a transaction is indeed *not* orderly, the reporting entity places little, if any, weight (in comparison with other indications of fair value) on that transaction price when measuring fair value or estimating market risk premiums.

On the other hand, if the evidence indicates that a transaction is in fact orderly, the reporting entity is to consider that transaction price when measuring fair value or estimating market risk premiums. The weight to be placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances—such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured, and the proximity of the transaction to the measurement date.

The IFRS does not preclude the use of quoted prices provided by third parties—such as pricing services or brokers—when the entity has determined that the quoted prices provided by those parties are determined in accordance with the standard. If a market is not active, however, the entity must evaluate whether the quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, however, the entity should place less weight on quotes that do not reflect the result of transactions.

### ***Selection of the valuation premise for asset measurements***

The measurement of the fair value of a non-financial asset is to assume the highest and best use of that asset by market participants. Generally, the highest and best use is the way that market participants would be expected to deploy the asset (or a group of assets and liabilities within which they would use the asset) that would maximize the value of the asset (or group). This highest and best use assumption might differ from the way that the reporting entity is currently using the asset or group of assets or its future plans for using it (them).



At the measurement date, the highest and best use must be physically possible, legally permissible and financially feasible. In this context, *physically possible* takes into account the physical characteristics of the asset that market participants would consider when pricing the asset (e.g., the location or size of a property). *Legally permissible* takes into account any legal restrictions on the use of the asset that market participants would consider when pricing the asset (e.g., the zoning regulations applicable to a property). *Financially feasible* takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into consideration the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use.

**Example: Restriction on the sale of an equity instrument (IFRS 13.IE28)**

An entity holds an equity instrument (a financial asset) for which sale is contractually restricted for a specified period. The restriction is a characteristic of the instrument and would be transferred to market participants. Thus fair value would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment reflects the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment varies depending on:

- The nature and duration of the restriction;
- The extent to which buyers are limited by the restriction; and
- Qualitative and quantitative factors specific to both the instrument and the issuer.

In all cases, the highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. The highest and best use of an asset acquired in a business combination might differ from the intended use of the asset by the acquirer. The highest and best use is normally the use for which an asset is currently engaged unless market or other factors indicate otherwise. For example, for competitive or other reasons, the acquirer may intend not to use an acquired asset actively or it may not intend to use the asset in the same way as other market participants. This may particularly be the case for certain acquired intangible assets, for example, an acquired trademark that competes with an entity's own trademark. Nevertheless, the reporting entity is to measure the fair value of the asset assuming its highest and best use by market participants.

**Example: Highest and best use versus current use (IFRS 13.IE7-8)**

An entity acquires land in a business combination, which is currently developed for industrial use as a site for a factory. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. The entity determines that the land currently used as a site for a factory could be developed as a site for residential use.

The highest and best use of the land would be determined by comparing both of the following:

- a. The value of the land as currently developed for industrial use (i.e. the land would be used in combination with other assets, such as the factory, or with other assets and liabilities)
- b. The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (i.e. the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of those values.

Where the highest and best use of an asset is determined by its use in conjunction with other assets and liabilities, fair value should be determined on that basis, thereby assuming that the asset would be used with other assets and liabilities and that those assets and liabilities (i.e., its complementary assets and the associated liabilities) would be available to market participants. Consequently the fair value of all other assets in that group of associated assets and liabilities should be determined on the same basis.

### ***Risk assumptions when valuing a liability***

Many accountants, analysts and others find the concept of computing fair value of liabilities and recognizing changes in the fair value thereof to be counterintuitive. Consider the case when a reporting entity's own credit standing declines (universally acknowledged as a "bad thing"). A fair value measurement that incorporates the effect of this decline in credit rating would result in a decline in the fair value of the liability and a resultant increase in stockholders' equity (which would be seen as a "good thing"). Nonetheless, the logic of measuring the fair value of liabilities is as valid, and as useful, as it is for assets. The IFRS does not expand the applicability of fair value measures from what currently exists, however.

Based on the market value concept and the associated sale price, IFRS 13 focuses on the transaction approach when measuring the fair value of liabilities. Applying the transfer approach involves recognizing the amount that would be payable in the marketplace for the hypothetical transfer of a liability. This includes the cash flows that are still probably due and may need to be discounted. Accordingly, IFRS 13.34 assumes that the debt relationship continues in a modified form, and that therefore the liability continues to exist at the time of transfer, with only the identity of the debtor changing. No distinction is made between financial and non-financial assets. Fair value measurements of liabilities assume that a hypothetical transfer to a market participant occurs on the measurement date. In measuring the fair value of a liability, the evaluator is to assume that the reporting entity's obligation to its creditor (i.e., the counterparty to the obligation) will continue at and after the measurement date (i.e., the obligation will not be repaid or settled prior to its contractual maturity). This being the case, this hypothetical transfer price would most likely represent the price that the current creditor (holder of the debt instrument) could obtain from a marketplace participant willing to purchase the debt instrument in a transaction involving the original creditor assigning its rights to the purchaser. In effect, the hypothetical market participant that purchased the instrument would be in the same position as the current creditor with respect to expected future cash flows (or expected future performance, if the liability is not able to be settled in cash) from the reporting entity.

The evaluator is to further assume that the non-performance risk related to the obligation would be the same before and after the hypothetical transfer occurs. Non-performance risk is the risk that the obligation will not be fulfilled. It is an all-encompassing concept that includes the reporting entity's own credit standing but also includes other risks associated with the non-fulfillment of the obligation. For example, a liability to deliver goods and/or perform services may bear non-performance risk associated with the ability of the debtor to fulfill the obligation in accordance with the timing and specifications of the contract. Further, nonperformance risk increases or decreases as a result of changes in the fair value of credit enhancements associated with the liability (e.g., collateral, credit insurance and/or guarantees).

**Example: Non-performance risk (IFRS 13.IE32)**

Entity A and Entity B each enter into a contractual obligation to pay an amount of €500 to Entity C in five years. Entity A has a AA credit rating and can borrow at 6% p.a., Entity B has a BBB credit rating and can borrow at 12% p.a.. Entity A will receive about €374 in exchange for its promise (the present value of €500 in five years at 6 %). Entity B will receive about €284 in exchange for its promise (the present value of €500 in five years at 12 %). The fair value of the liability to each entity (i.e. the proceeds) incorporates that entity's credit standing.

As with the valuation of assets, company-specific elements are also ignored when measuring liabilities. Accordingly, valuations do not consider more favourable cost structures, for example, for non-financial liabilities, nor credit terms and conditions that may be more or less favourable than the market norm. To meet the objective of a fair value measurement in accordance with IFRS 13, an entity shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs. In order to meet this requirement even if there is no observable market to provide pricing information about the transfer of a liability, there might be an observable market for such items if they are held by other parties as assets (e.g., a corporate bond).

***Liabilities and equity instruments held by other (third) parties as asset***

When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date. The IASB is convinced that the fair value from the viewpoint of investor and issuer should be the same in an efficient market.

In the case where a third party held the liability or equity instrument, an entity shall measure the fair value as follows:

- (a) Using the quoted price in an active market for the identical item held by another party as an asset, if that price is available.
- (b) If that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset.
- (c) If the observable prices in (a) and (b) are not available, using another valuation technique, such as:
  - a. An income approach (e.g., a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset);
  - b. A market approach (e.g., using quoted prices for similar liabilities or equity instruments held by other parties as assets).

An entity shall adjust the price of a liability or an entity's own equity instrument held by another party as an asset only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument. According to the IASB adjustments are made such as:

- i. The quoted price for the asset relates to a similar (but not identical) liability or equity instrument held by another party as an asset. For example, the liability or equity instrument may have a particular characteristic (e.g., the credit quality of the issuer) that

is different from that reflected in the fair value of the similar liability or equity instrument held as an asset.

- ii. The unit of account for the asset is not the same as for the liability or equity instrument. For example, for liabilities, in some cases the price for an asset reflects a combined price for a package comprising both the amounts due from the issuer and a third-party credit enhancement. If the unit of account for the liability is not for the combined package, the objective is to measure the fair value of the issuer's liability, not the fair value of the combined package. Thus, in such cases, the entity would adjust the observed price for the asset to exclude the effect of the third-party credit enhancement.

### ***Liabilities and equity instruments not held by other (third) parties as asset***

There are certain liabilities that are not held by a third party as an asset. An example is a decommissioning liability assumed in a business combination, warranty obligations, and many other performance commitments.

In this respect, the accounting entity must determine the fair value of the liabilities or of the equity instrument by applying valuation methods from the perspective of a market participant who must honour the claims to payment from the liability or from the equity instrument.

These valuation techniques can include a present value technique that considers either:

- i. Future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation; or
- ii. The amount that a market participant would receive to enter into or issue an identical liability or equity instrument, using the assumptions that market participants would use when pricing the identical item (e.g., having the same credit characteristics) in the principal (or most advantageous) market for issuing a liability or an equity instrument with the same contractual terms.

When using a present value technique to measure the fair value of a liability that is not held by another party as an asset, an entity shall, among other things, estimate the future cash outflows that market participants would expect to incur in fulfilling the obligation. Those future cash outflows shall include market participants' expectations about the costs of fulfilling the obligation and the compensation that a market participant would require for taking on the obligation. Such compensation includes the return that a market participant would require for the following:

- i. Undertaking the activity (i.e., the value of fulfilling the obligation; e.g., by using resources that could be used for other activities); and
- ii. Assuming the risk associated with the obligation (i.e., a risk premium that reflects the risk that the actual cash outflows might differ from the expected cash outflows).

For example, a non-financial liability does not contain a contractual rate of return and there is no observable market yield for that liability. In some cases the components of the return that market participants would require will be indistinguishable from one another (e.g., when using the price a third-party contractor would charge on a fixed-fee basis). In other cases an entity needs to estimate those components separately (e.g., when using the price a third-party contractor would charge on a cost-plus basis because the contractor in that case would not bear the risk of future changes in costs).

**Non-performance risk in valuing liabilities.** The fair value of a liability reflects the effect of *non-performance risk*, which is the risk that an entity will not fulfill an obligation. For valuation purposes, non-performance risk is assumed to be the same before and after the transfer of the liability. This assumption is rational, because market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price.

Non-performance risk includes credit risk, the effect of which may differ depending on the nature of the liability. For example, an obligation to deliver cash (a financial liability) is distinct from an obligation to deliver goods or services (a non-financial liability). Also, the terms of credit enhancements related to the liability, if any, would impact valuation.

**Liabilities with inseparable third-party credit enhancements.** Creditors often impose a requirement, in connection with granting credit to a debtor, that the debtor obtain a guarantee of the indebtedness from a creditworthy third party. Under such an arrangement, should the debtor default on its obligation, the third-party guarantor would become obligated to repay the obligation on behalf of the defaulting debtor and, of course, the debtor would be obligated to repay the guarantor for having satisfied the debt on its behalf.

The issuer of a liability issued with an inseparable third party credit enhancement that is accounted for separately from the liability shall not include the effect of the credit enhancement in the fair value measurement of the liability. If the credit enhanced is accounted for separately from the liability, the issuer should take into account its own credit standing and not that of the third party guarantor.

#### ***Restriction preventing the transfer of a liability or an entity's own equity instrument***

If there are restrictions on the transfer of a liability or equity instrument, which is not an uncommon feature in certain circumstances, that should not be a consideration when measuring the fair value of such an instrument. The IFRS takes the view that the effect of such a feature is already included in other inputs to the fair value measurement of such instruments.

#### ***Financial liability with a demand feature***

The fair value of financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

#### ***Shareholder's equity***

IFRS 13 is equally applicable to the entity's equity instruments. These include the entity's own equity instruments, and how these are issued as consideration in the course of a business combination, for example. The valuation procedure adheres to the same regulations that govern the valuation of liabilities. Accordingly, own equity instruments are valued from the perspective of a market participant who holds the instrument as an asset. If such an instrument is not held as an asset by a third party, it is measured using a valuation procedure that reflects the assumptions of the market participant, in line with the regulations governing the valuation of liabilities. One such typical valuation method might be the income approach.

#### ***Fair value for net exposures***

Where an entity manages a portfolio of financial assets and liabilities with a view to managing net exposures to counterparty risk including credit and market risks, the standard permits that fair value may be determined for the net long (asset) or short (liability) position.

This exception is available only if the entity qualifies for that exception by demonstrating that the net exposure is consistent with how it manages risk and it has elected to measure the financial assets and liabilities at fair value. Fair value would therefore be determined on the basis of what market participants would take into consideration when considering a transaction on the net exposure risks.

The exception does not however extend to the presentation of such net exposures in the financial statements, unless otherwise permitted by another IFRS.

As part of its Annual Improvements project 2010–2012, the IASB clarified that issuing IFRS 13 and revising IFRS 9 (B5.4.12) and IAS 39 (AG 79) had not resulted in the abolition of the option of measuring short-term receivables and payables with no stated interest rate at invoice amount, without discounting them, as long as the effects of not discounting them were not material.

The Annual Improvements project 2011–2013 added a new section 52 to IFRS 13, which specifies the area of application of section 48 of the standard. It clarifies that the portfolio exception in section 52 of IFRS 13 applies to all contract accounting within the scope of IAS 39, *Financial Instruments: Recognition and Measurement* or IFRS 9, *Financial Instruments*, regardless of whether the contracts meet the definitions of financial assets or financial liabilities as defined in IAS 32, *Financial Instruments: Presentation*.

### **Inputs**

For the purpose of fair value measurements, inputs are the assumptions that market participants would use in pricing an asset or liability, including assumptions regarding risk. An input is either observable or unobservable. Observable inputs are either directly observable or indirectly observable. The IFRS requires the entity to maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

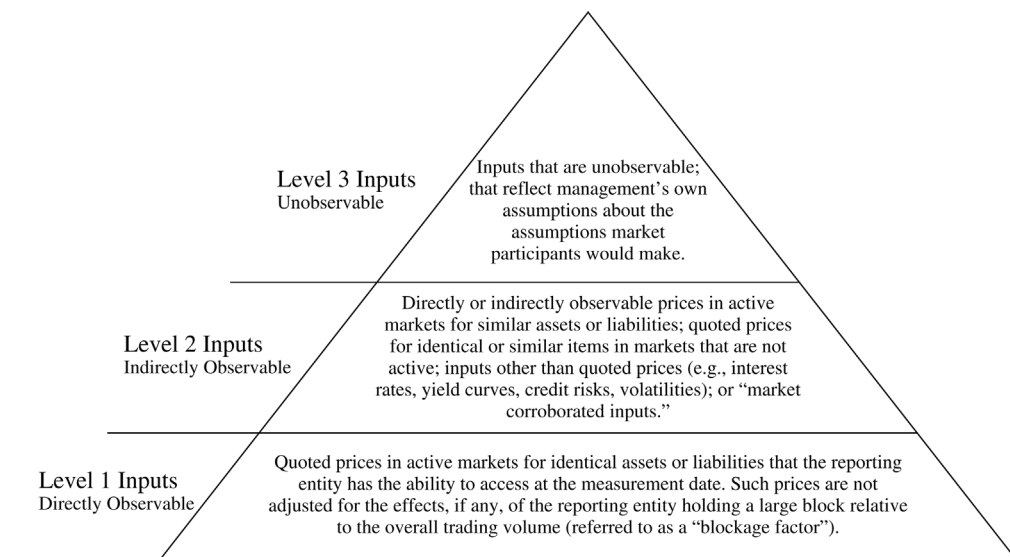
An entity shall select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability. In some cases those characteristics result in the application of an adjustment, but adjustments are solely applicable for characteristics of the asset or liability which are consistent with the unit of account in the IFRS that requires or permits the fair value measurement.

An observable input is based on market data obtainable from sources independent of the reporting entity. For an input to be considered relevant, it must be considered determinative of fair value. Examples of markets in which inputs might be observable for some assets and liabilities include exchange markets, dealer markets broker markets and principal-to-principal markets.

An unobservable input reflects assumptions made by management of the reporting entity with respect to assumptions it believes market participants would use to price an asset or liability based on the best information available under the circumstances.

The standard provides a fair value input hierarchy (see diagram below) to serve as a framework for classifying inputs based on the extent to which they are based on observable data. In some instances inputs used in a valuation technique may be categorized at different levels across the hierarchy; in such instances the fair value measurement is categorized in the same level as the lowest level of input significant to the measurement of fair value. Determining significance in this context requires the use of judgement. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorized.

The fair value hierarchy is determined by the predominant input factor with the aim of maximizing the use of observable input parameters and keeping non-observable input parameters to the lowest possible minimum. The measurement method (measurement technique) that is applied is dictated by the available data, since the adopted measurement method constitutes the appropriate procedure for the given circumstances, and sufficient data is available to measure the fair value using that method.



Hierarchy of Fair Value Inputs

**Level 1 inputs.** Level 1 inputs are considered the most reliable evidence of fair value and are to be used whenever they are available. These inputs consist of quoted prices in active markets for identical assets or liabilities. The active market must be the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability in which the reporting entity has the ability to enter into a transaction for the asset or liability at the price in that market at the measurement date. A quoted price in an active market is the most reliable evidence of fair value and should be used without adjustment except in the following circumstances:

1. As a practical expedient where an entity holds a large number of similar but non-identical assets and liabilities that are measured at fair value and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities without difficulty. The entity may use a pricing alternative (e.g., pricing matrix) but the resultant fair value will be categorized as lower than Level 1.
2. When a quoted price in an active market does not reflect fair value at measurement date, for example when there is a significant after-market transaction which takes place after the close of a market but before the measurement date. If an adjustment is made in this regard the resultant fair value will be categorized as lower than Level 1.
3. Where the fair value of a liability or an entity's own equity instrument is determined using the quoted price for the identical asset adjusted for features present in the asset but not the liability. The resultant fair value is categorized as lower than Level 1.

Under no circumstances, however, is management to adjust the quoted price for blockage factors. Blockage adjustments arise when an entity holds a position in a single financial instrument that is traded on an active market that is relatively large in relation to the market's daily trading volume. That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

**Level 2 inputs.** Level 2 inputs are inputs for the asset or liability (other than quoted prices within Level 1) that are either directly or indirectly observable. Level 2 inputs are to be considered when quoted prices for the identical asset or liability are not available. If the asset or liability being measured has a contractual term, a Level 2 input must be observable for substantially the entire term. These inputs include:

1. Quoted prices for *similar* assets or liabilities in active markets.
2. Quoted prices for identical or similar assets or liabilities in markets that are *not active*.
3. Inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates and yield curves observable at commonly quoted intervals; implied volatilities; prepayment speeds; loss severities; credit risks; and default rates).
4. Inputs that are derived principally from or corroborated by observable market data that, through correlation or other means, are determined to be relevant to the asset or liability being measured (market-corroborated inputs).

Adjustments made to Level 2 inputs necessary to reflect fair value, if any, will vary depending on an analysis of specific factors associated with the asset or liability being measured. These factors include:

1. Condition.
2. Location.
3. Extent to which the inputs relate to items comparable to the asset or liability.
4. Volume and level of activity in the markets in which the inputs are observed.

Depending on the level of the fair value input hierarchy in which the inputs used to measure the adjustment are classified, an adjustment that is significant to the fair value measurement in its entirety could render the measurement a Level 3 measurement.

During the turmoil experienced in credit markets beginning in early 2008, a holder of collateralized mortgage obligations (CMOs) backed by a pool of subprime mortgages might determine that no active market exists for the CMOs. Management might use an appropriate ABX credit default swap index for subprime mortgage bonds to provide a Level 2 fair value measurement input in measuring the fair value of the CMOs.

**Level 3 inputs.** Level 3 inputs are unobservable inputs. These are necessary when little, if any, market activity occurs for the asset or liability. Level 3 inputs are to reflect management's own assumptions about the assumptions regarding an exit price that a market participant holding the asset or owing the liability would make including assumptions about risk. The best information available in the circumstances is to be used to develop the Level 3 inputs. This information might include internal data of the reporting entity. Cost-benefit considerations apply in that management is not required to "undertake all possible efforts" to obtain information about the assumptions that would be made by market participants. Attention is to be paid, however, to information available to management without undue cost and effort and, consequently, management's internal assumptions used to develop unobservable inputs are to be adjusted if such information contradicts those assumptions.



**Inputs based on bid and ask prices.** Quoted bid prices represent the maximum price at which market participants are willing to buy an asset; quoted ask prices represent the minimum price at which market participants are willing to sell an asset. If available market prices are expressed in terms of bid and ask prices, management is to use the price within the bid-ask spread (the range of values between bid and ask prices) that is most representative of fair value irrespective of where in the fair value hierarchy the input would be classified. The standard permits the use of pricing conventions such as midmarket pricing as a practical alternative for determining fair value measurements within a bid-ask spread.

### *Valuation techniques*

In measuring fair value, management may employ one or more valuation techniques consistent with the market approach, the income approach, and/or the cost approach. As previously discussed, the selection of a particular technique (or techniques) to measure fair value is to be based on its appropriateness to the asset or liability being measured and in particular the sufficiency and observability of inputs available.

In certain situations, such as when using Level 1 inputs, use of a single valuation technique will be sufficient. In other situations, such as when valuing a reporting unit, management may need to use multiple valuation techniques. When doing so, the results yielded by applying the various techniques are to be evaluated and appropriately weighted based on judgement as to the reasonableness of the range of results. The objective of the weighting is to determine the point within the range that is most representative of fair value.

If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. Calibration ensures that the valuation technique reflects current market conditions, and it helps an entity to determine whether an adjustment to the valuation technique is necessary (e.g., there might be a characteristic of the asset or liability that is not captured by the valuation technique).

Management is required to consistently apply the valuation techniques it elects to use to measure fair value. It would be appropriate to change valuation techniques or how they are applied if the change results in fair value measurements that are equally or more representative of fair value. Situations that might give rise to such a change would be when new markets develop, new information becomes available, previously available information ceases to be available, or improved techniques are developed. Revisions that result from either a change in valuation technique or a change in the application of a valuation technique are to be accounted for as changes in accounting estimate under IAS 8.

**Market approaches.** Market approaches to valuation use information generated by actual market transactions for identical or comparable assets or liabilities (including a business in its entirety). Market approach techniques often will use market multiples derived from a set of comparable transactions for the asset or liability or similar items. The entity will need to consider both qualitative and quantitative factors in determining the point within the range that is most representative of fair value. An example of a market approach is matrix pricing. This is a mathematical technique used primarily for the purpose of valuing debt securities without relying solely on quoted prices for the specific securities. Matrix pricing uses factors such as the stated interest rate, maturity, credit rating and quoted prices of similar issues to develop the issue's current market yield.

**Income approaches.** Techniques classified as income approaches measure fair value based on current market expectations about future amounts (such as cash flows or net income) and discount them to an amount in measurement date dollars. Valuation techniques that follow an income approach include present value techniques, option pricing models, such as the Black-Scholes-Merton model (a closed-form model), and binomial, i.e., a lattice model (an open-form model), which incorporate present value techniques, as well as the multi-period excess earnings method that is used in fair value measurements of certain intangible assets such as in-process research and development.

**Cost approaches.** Cost approaches are based on quantifying the amount required to replace an asset's remaining service capacity (i.e., the asset's current replacement cost) from the perspective of a market participant buyer. A valuation technique classified as a cost approach would measure the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence adjustments include factors for physical wear and tear, improvements to technology, and economic (external) obsolescence. Thus, obsolescence is a broader concept than financial statement depreciation, which simply represents a cost allocation convention and is not intended to be a valuation technique.

**Example: Multiple valuation techniques – machine held and used (IFRS 13.IE11-13)**

An Entity acquires a machine in a business combination, which will be held and used in its operations. The machine was originally purchased from an outside vendor and was customized by the acquired entity for use in its operations. However the customization of the machine was not extensive. The entity determines that sufficient data are available to apply the cost approach and because the customization was not extensive the market approach. The income approach is not used because the machine does not have a separately identifiable income stream.

- a. The market approach is applied using quoted prices for similar machines adjusted for differences between the machine (as customized) and the similar machines. The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use). The fair value indicated by that approach ranges from €40.000 to €48.000.
- b. The cost approach is applied by estimating the amount that would be required currently to construct a substitute (customized) machine of comparable utility. The estimate takes into account the condition of the machine and the environment in which it operates, including physical wear and tear, improvements in technology, external conditions such as a market decline in the demand for similar machines and installation costs. The fair value indicated by that approach ranges from €40.000 to €52.000.

The entity determines that the higher end of the range indicated by the market approach is most representative of fair value. That determination is made on the basis of the relative subjectivity of the inputs:

- The inputs in the market approach (quoted prices for similar machines) require fewer and less subjective adjustments than the inputs used in the cost approach.
- The range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.
- There are no known unexplained differences (between the machine and the similar machines) within that range.

Accordingly, the entity determines that the fair value of the machine is €48.000.

## Measurement Considerations

**Initial recognition.** When the reporting entity first acquires an asset or incurs (or assumes) a liability in an exchange transaction, the transaction price represents an entry price, the price paid to acquire the asset and the price received to assume the liability. Fair value measurements are based not on entry prices, but rather on exit prices; the price that would be received to sell the asset or paid to transfer the liability. In some cases (e.g., in a business combination) there is not a transaction price for each individual asset or liability. Likewise, sometimes there is not an exchange transaction for the asset or liability (e.g., when biological assets regenerate).

While entry and exit prices differ conceptually, in many cases they may be nearly identical and can be considered to represent fair value of the asset or liability at initial recognition. This is not always the case, however, and in assessing fair value at initial recognition, management is to consider transaction-specific factors and factors specific to the assets and/or liabilities that are being initially recognized.

Examples of situations where transaction price is not representative of fair value at initial recognition include:

1. Related-party transactions, although the price in a related party transaction may be used as an input into a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
2. Transactions taking place under duress such as a forced or liquidation transaction. Such transactions do not meet the criterion in the definition of fair value that they be representative of an “orderly transaction.”
3. Different units of account that apply to the transaction price and the assets/liabilities being measured. This can occur, for example, where the transaction price includes other elements besides the assets/liabilities that are being measured such as unstated rights and privileges that are subject to separate measurement or when the transaction price includes transaction costs (see discussion below).
4. The exchange transaction takes place in a market different from the principal (or most advantageous) market in which the reporting entity would sell the asset or transfer the liability. An example of this situation is when the reporting entity is a securities dealer that enters into transactions in different markets depending on whether the counterparty is a retail customer or another securities dealer.

**Transaction costs.** Transaction costs are the incremental direct costs that would be incurred to sell an asset or transfer a liability. While, as previously discussed, transaction costs are considered in determining the market that is most advantageous, they are not used to adjust the fair value measurement of the asset or liability being measured. IASB excluded them from the measurement because they do not represent an attribute of the asset or liability being measured.

**Transport costs.** If an attribute of the asset or liability being measured is its location, the price determined in the principal (or most advantageous) market is to be adjusted for the costs that would be incurred by the reporting entity to transport it to or from that market.

The possible discrepancies between entry and exit values may create so-called “day one gains or losses.” If an IFRS requires or permits an entity to measure an asset or liability initially at fair value and the transaction price differs from fair value, the entity recognizes the resulting gain or loss in profit or loss unless the IFRS requires otherwise.

## FAIR VALUE DISCLOSURE

The IFRS on fair value measurement provides that, for assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the reporting entity is to disclose information that enables users of its financial statements to assess the methods (valuation technique) and inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the entity has to disclose the effect of the measurements on profit or loss or other comprehensive income for the period. To accomplish these objectives, it must (except as noted below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the extent of aggregation or disaggregation, and whether users need any additional (qualitative) information to evaluate the quantitative information disclosed. An entity shall present the quantitative disclosures required in a tabular format unless another format is more appropriate.

The disclosures in the Notes distinguish between recurring or non-recurring fair value measurement. More detailed information must be provided for recurring fair value measurements.

At a minimum, the entity is to disclose the following information for each class of assets and liabilities:

1. The fair value measurement at the end of the reporting period. In addition, for non-recurring fair value measurements, the reasons for the measurement.
2. The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2 or 3).
3. For assets and liabilities held at the reporting date that are measured at fair value on a recurring basis, any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level are to be disclosed and discussed separately from transfers out of each level. For this purpose, significance is to be judged with respect to profit or loss, and total assets or total liabilities.
4. For recurring and non-recurring fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, the methods and the inputs used in the fair value measurement and the information used to develop those inputs. If there has been a change in valuation technique (e.g., changing from a market approach to an income approach), the entity must disclose that change, the reasons for making it, and its effect on the fair value measurement. In case entities utilize within Level 3 of the fair value hierarchy quantitative information about the significant unobservable inputs, this quantitative information has to be disclosed.

### Example: Valuation techniques and inputs (IFRS 13.IE63)

Description	Fair Value at 31.12.20X9	Valuation technique	Unobservable input	Range (weighted average)
Other equity securities – healthcare industry	53	Discounted Cash Flow	Weighted-Average Cost of Capital	7%–16% (12,1%)  2%–5% (4,2%)

			Long-term revenue growth rate	
			Long-term pre-tax operating margin	3%–20% (10,3%)
			Discount for lack of marketability	5%–20% (17%)
		Market comparable companies	Control premium	10%–30% (20%)
			EBITDA multiple	10–13 (11,3)
			Revenue multiple	1,5–2,0 (1,7)
			Discount for lack of marketability	5%–20% (17%)
			Control premium	10%–30% (20%)
- energy industry	32	Discounted Cash Flow	Weighted average Cost of Capital	8%–12% (11,1%)
			Long-term revenue growth rate	3%–5,5% (4,2%)
			Long-term pre-tax operating margin	7,5%–13% (9,2%)
			Discount for lack of marketability	5%–20% (10%)
		Market comparable companies	Control premium	10%–20% (12%)
			EBITDA multiple	6,5–12 (9,5)
			Revenue multiple	1,0–3,0 (2,0)
			Discount for lack of marketability	5%–20% (10%)
			Control premium	10%–20% (12%)
Debt securities				
- Residential Mortgage-backed securities	125	Discounted Cash Flow	Constant prepayment rate	3,5%–5,5% (4,5%)
			Probability of default	5%–50% (10%)
			Loss severity	40%–100% (60%)
- Collateralized Debt Obligations	35	Consensus pricing	Offered quotes	20–45
			Comparability adjustments (%)	–10% – +15% (+5%)
Derivatives				
- Credit Contracts	38	Option model	Annualized volatility of credit	10%–20%
			Counterparty credit risk	0,5%–3,5%
			Own credit risk	0,3%–2%
Investment properties				
- Commercial - Asia	31	Discounted Cash Flow	Long term net operating income margin	18%–32% (20%)
			Cap rate	0,08–0,12 (0,10)
		Market comparable approach	Price per square metre (USD)	\$ 3.000–\$ 7.000 (\$ 4.500)
- Commercial - Europe	27	Discounted Cash Flow	Long term net operating income margin	15%–25% (18%)
			Cap rate	0,06–0,10 (0,08)
		Market comparable approach	Price per square metre (USD)	\$ 4.000–\$ 12.000 (\$ 8.500)

5. For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:
  - a. Total gains or losses for the period recognized in profit or loss, and a description of where they are presented in the statement of comprehensive income or the separate income statement (if presented).
  - b. Total gains or losses for the period recognized in other comprehensive income and a description of where they are presented in the other comprehensive income.
  - c. Purchases, sales, issues and settlements (each of those types of change disclosed separately).
  - d. Transfers into or out of Level 3 (e.g., transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3. For this purpose, significance shall be judged with respect to profit or loss, and total assets or total liabilities.
6. The amount of the total gains or losses for the period in 5a. above included in profit or loss that are attributable to gains or losses relating to those assets and liabilities held at the reporting date, and a description of where those gains or losses are presented in the statement of comprehensive income or separate income statement (if presented).
7. For recurring and non-recurring fair value measurements categorized within Level 3, a description must be provided of the valuation processes used by the entity, including the measurement strategy and method, as well as the procedure for analysing changes in the fair value between the periods.
8. For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs (used in valuation) if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between unobservable inputs used in the fair value measurement, an entity shall also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

For recurring financial assets and financial liabilities, if changing one or more of the unobservable inputs to reasonably possible alternative assumptions would change fair value significantly, the entity is to state that fact and disclose the effect of those changes. An entity is to disclose how it calculated those changes. For this purpose, significance is to be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognized in other comprehensive income, total equity.

**Example: Description about sensitivity to changes in significant unobservable inputs (IFRS 13. IE66):**

The significant unobservable inputs used in the fair value measurement of the entity's residential mortgage backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the

assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

9. For recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.
10. The appropriate classification of assets and liabilities is determined, on the one hand, on the basis of the properties, attributes and risks attached to the asset or liability, and its respective level in the measurement hierarchy. Since measuring fair value at Level 3 involves a higher degree of uncertainty and subjectivity, the number of classes at this hierarchy level may need to be larger than for Levels 1 or 2. A class of assets or liabilities frequently needs to be broken down into more detail than that which is reflected by the individual items on a statement of financial position.

In addition to the foregoing, for each class of assets and liabilities *not* measured at fair value (recurring and non-recurring) in the statement of financial position, but for which the fair value is disclosed, the reporting entity is to disclose the fair value by the level of the fair value hierarchy, for fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique and the inputs used in the fair value measurement as well as in case reasons for changing the valuation technique. In addition, if an asset's current use differs from its best use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.

## EDUCATION MATERIAL

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The IFRS Foundation Education Initiative is developing educational material to support the implementation of IFRS 13. The material will cover the application of the principles in IFRS 13 across a number of topics. These topics will be published in individual chapters as they are completed.

The first chapter deals with measuring the fair value of unquoted equity instruments. Note that the educational material does not constitute official requirements of the IASB, but is merely published to assist entities with the implementation and application of the IFRS 13 requirements. The guidance applies to the fair value of unquoted equity instruments within the scope of IFRS 9. IFRS 9 applies to investments in equity instruments where the investor holds a non-controlling interest which:

- It is not required to be accounted for as an associate, joint venture or joint arrangement in its consolidated or individual financial statements;
- It is not an interest in a subsidiary, associate, joint venture or joint arrangement unless the investor has elected to measure those investments in accordance with IFRS 9 in the separate financial statements.

IFRS 9 requires all investments in equity instruments that are within its scope to be measured at fair value, regardless of whether they are quoted or unquoted. The problem in practice is that market prices are not always available for unquoted instruments. The

educational material gives guidance on how to measure the fair value of an unquoted equity instrument even if only limited financial information is available. The three valuation approaches and techniques described are:

1. Market approach:
  - a. Transaction price paid for an identical or a similar instrument in an investee.
  - b. Comparable company valuation multiples.
2. Income approach:
  - a. Discounted cash flow method.
  - b. Dividend discount model.
3. Adjusted net asset method.

Note that the guidance does not prescribe any one method above the other, but requires an entity using the guide to apply judgement in determining which approach should be used. Below is a summary of the three approaches detailed in the guide. The full guide, as well as the examples therein, is available from the IASB website ([www.IFRS.org](http://www.IFRS.org)).

1. Market approach

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets. The following valuation techniques are described under the market approach in the document:

- Transaction price paid for an identical or a similar instrument of an investee.
- Comparable company valuation multiples (typically trading or transaction multiples).

Where there has been a recent acquisition of the identical equity instruments in the same entity, that price would be indicative of the fair value of the instrument. For example, if another third party had purchased 5% of the same company recently for \$500,000, then it would be reasonable to assume that this would be indicative of a similar holdings value. Note that the investor should assess whether factors or events that have occurred after the purchase date that could affect the fair value of the unquoted equity instrument at measurement date. If so, the value would need to be adjusted for these factors.

If the equity instrument that was recently acquired is *similar* to the unquoted equity instrument being valued, the investor needs to understand, and make adjustments for, any differences between the two equity instruments. These could include economic rights (e.g., dividend rights, priority upon liquidation, etc.) and control rights (i.e., control premium).

Comparable company valuation multiples assume that the value of an unquoted asset can be measured by comparing that investment to a similar investment where market prices are available. There are two main sources of information about the pricing of comparable company peers: quoted prices in exchange markets (for example, the Singapore Exchange or the Frankfurt Stock Exchange) and observable data from transactions such as mergers and acquisitions. In doing a comparable company valuation (trading multiples or transaction multiples), you would need to ascertain the following:

- i. Identify a comparable peer company for which information is available.
- ii. Select the performance measure that is most relevant to assessing the value for the investee (i.e., earnings, equity book value or revenue). Once selected, derive



and analyse possible valuation multiples and select the most appropriate one (e.g., EBIT, EBITA, EBITDA or P/E). Note that this may need to be adjusted for differences between the companies that may impact the multiple being used. (e.g., size of the business where revenues are being used).

- iii. Apply the appropriate valuation multiple to the relevant performance measure of the investee to obtain an indicated fair value of the investee's equity value or the investee's enterprise value.
- iv. To ensure comparability between the unquoted equity instruments held in the investee and the equity instruments of the comparable company peers, further adjustment may be required to the derived multiple before applying it to reflect the effect of factors such as:
  - a. **Non-controlling discount** (for instance, if the multiple is derived from the price in an acquisition involving the acquisition of control, the derived multiple will include the effect of the control premium which must be removed in determining the appropriate multiple for the valuation of your non-controlling investment).
  - b. **Liquidity effect**: it is accepted that unlisted entities have a tendency to trade at a discount to fair value compared to comparable peer companies which are listed. This discount should be determined and adjusted for.
  - c. Isolation of **non-core activities**: for the purposes of deriving the value generated by an investee's operating assets and liabilities an investor must remove non-operating items effect (including any income or expenses they generate) from both the valuation multiple obtained from the comparable company peers (see ii) and from the investee's performance measure (see iii).

## 2. Income approach

The income approach is a valuation technique that converts future amounts (e.g., cash flows or income and expenses) to a single current (i.e., discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. The guide details the following valuation techniques:

### *Discounted cash flow method*

DCF method is generally applied by projecting expected cash flows for a discrete period (e.g., three to five years) and then determining a value for the periods thereafter (terminal value) and discounting the projected cash flows to a present value at a rate reflecting the time value of money and the relative risks of the investment.

### *Dividend discount model*

The DDM assumes the price (fair value) of an entity's equity instrument equals the present value of all its expected future dividends in perpetuity. This method is most applicable to entities that are consistent dividend payers.

### *Constant-growth dividend discount model*

The constant-growth DDM is the same as the dividend discount method but applies a simplified assumption of a constant growth rate in dividends. This method is most suitable for mature enterprises with a consistent dividend policy.

### *Capitalization model*

The capitalization method applies a rate to an amount that represents a measure of economic income (e.g., free cash flows to firm or free cash flows to equity) to arrive

at an estimate of present value. The model is useful as a cross-check when other approaches have been used.

3. Adjusted net asset method.

The adjusted net asset method assumes that the fair value is best represented by the fair value of an investee's assets and liabilities (recognized and unrecognized). This method is most applicable to entities which generate a return from holding assets rather than from deploying them, e.g., investment entities or property investment business. It may also be suitable for early stage enterprises with no meaningful financial history. The resulting fair values of the recognized and unrecognized assets and liabilities should represent the fair value of the investee's equity. In short, this method is akin to applying the valuation concepts in IFRS 3, *Business Combinations*, to the entity being valued.

## **FUTURE DEVELOPMENTS**

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In September 2014 the IASB issued ED/2014/4, "Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value" (proposed amendments to IFRS 10, IFRS 12, IAS 27, IAS 28 and IAS 36 and illustrative Examples for IFRS 13). The Exposure Draft states that the unit of account for the fair value measurement of investments in subsidiaries, joint ventures and associates when those investments are quoted in an active market (quoted investments) is the investment as a whole rather than the individual financial instruments included within that investment. The proposed amendments clarify that an entity should measure the fair value of quoted investments in subsidiaries, joint ventures and associates and quoted CGUs as the product of the quoted price for the individual financial instrument and the quantity of financial instruments that make up the investments held by the entity without adjustments. Currently the IASB is discussing the comments received.

## **US GAAP COMPARISON**

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IFRS 13 mirrors closely the US GAAP fair value measurement standard with some small specific additional expediciencies and requirements:

- Under US GAAP, when accounting for alternative investments, a practical expedient allows entities to measure the fair value of certain investments at net asset value.
- Under US GAAP, a quantitative sensitivity analysis is required to be disclosed in the financial statements footnotes for all financial instruments categorized as Level 3 investment.

financial statements (whether prepared in accordance with various national GAAP or IFRS). The venerable matching principle (still having some relevance, although it is no longer a central concept underlying financial reporting rules) implies that for financial reporting purposes the amount presented as current period tax expense should bear an appropriate relationship to the amount of pre-tax accounting income being reported. That expense will normally not equal—and may differ markedly from—the amount of the current period's tax payment obligation. The upshot is that deferred income tax assets and/or liabilities must be recognized. These are measured, approximately, as the difference between the amounts currently owed and the amounts recognizable for financial reporting purposes.

Various theories of interperiod income tax allocation have been proposed and mandated over the years, both by various national GAAP and by IFRS. Under the current provisions of IAS 12, which was substantially revised effective in 1998, the *liability method* of computing interperiod income tax allocation is required. This method is oriented toward the statement of financial position, rather than the statement of profit or loss and other comprehensive income, and has as its highest objective the accurate, appropriate measurement of assets and liabilities, so that the statement of financial position representation of deferred tax benefits and obligations will comply with the definitions of assets and liabilities set forth by the IASB's *Framework*. In order to achieve this, at each statement of financial position date the amounts in the deferred tax asset and/or liability accounts must be assessed, with whatever adjustment(s) are needed to achieve the correct balance(s) being reported in the tax provisions for the period. In other words, tax expense is a residual, with the primary objective being achieving the correct balances in the deferred tax asset and liability accounts.

The statement of financial position liability method applied in IAS 12 focuses on temporary differences, which are the difference between the carrying value and tax base of all assets and liabilities. The income statement liability method applied previously focuses on timing differences, which was the difference between the amounts recognized in the accounting profit or loss and the taxable income for a reporting period.

Under IAS 12, deferred tax assets and liabilities are to be presented at the amounts that are expected to flow to or from the reporting entity when the tax benefits are ultimately realized or the tax obligations are settled. IAS 12 does not distinguish operating losses from other types of deductible temporary differences, and requires that both be given recognition, when realization is deemed to be *probable*. Discounting of these amounts to present values is not permitted, as debate continues about the role of discounting in the presentation of assets and liabilities on the statement of financial position. (Uncertainty about the timing of deferred tax realization or settlement makes discounting a practical challenge, also).

Both deferred tax assets and liabilities are measured by reference to expected tax rates, which in general are the enacted, effective rates as of the date of the statement of financial position. IAS 12 has particular criteria to be used for the recognition of the tax effects of temporary differences arising from ownership interests in investees and subsidiaries, and for the accounting related to goodwill arising from business acquisitions. Presentation of deferred tax assets or liabilities as current assets or liabilities is prohibited by the standard, which also establishes extensive financial statement disclosures.

#### Sources of IFRS

IAS 12

## SCOPE

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IAS 12 is applied in the accounting for income taxes. Income taxes include all domestic and foreign taxes which are based on taxable profit, including withholding taxes payable on distributions by the reporting entity. Although IAS 12 does not deal with the accounting of government grants and investment tax credits, it deals with the accounting of temporary differences on such transactions.

## DEFINITIONS OF TERMS

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**Accounting profit.** Net profit or loss for the reporting period before deducting income tax expense.

**Current tax expense (benefit).** The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

**Deductible temporary differences.** Temporary differences that result in amounts that are deductible in determining future taxable profit (tax loss) when the carrying amount of the asset or liability is recovered or settled.

**Deferred tax asset.** The amounts of income taxes recoverable in future periods in respect of deductible temporary differences, the carryforward of unused tax losses, and the carryforward of unused tax credits.

**Deferred tax expense (benefit).** The change during a reporting period in the deferred tax liabilities and deferred tax assets of an entity.

**Deferred tax liability.** The amounts of income taxes payable in future periods in respect of taxable temporary differences.

**Tax base.** The amount attributable to an asset or liability for tax purposes.

**Tax credits.** Reductions in the tax liability as a result of certain expenditures accorded special treatment under the tax regulations.

**Tax expense (tax income).** The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax

**Taxable profit (loss).** The profit (loss) for a taxable period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

**Taxable temporary differences.** Temporary differences that result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

**Temporary differences.** Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

## IDENTIFICATION

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Tax expense (income) comprises two components: current tax expense and deferred tax expense. Either of these can be an income (i.e., a credit amount in the statement of profit or loss and other comprehensive income), rather than an expense (a debit), depending on whether there is taxable profit or loss for the period. For convenience, the term “tax expense” will be used to denote either an expense or an income. Current tax expense is easily understood as the tax effect of the entity’s reported taxable income or loss for the period, as determined by relevant rules of the various taxing authorities to which it is subject.

Deferred tax expense, in general terms, arises as the tax effect of temporary differences occurring during the reporting period.

Using the liability method, the reporting entity's current period total income tax expense cannot be computed directly (except when there are no temporary differences). Rather, it must be calculated as the sum of the two components: current tax expense and deferred tax expense. This total will not, in general, equal the amount that would be derived by applying the current tax rate to pre-tax accounting profit. The reason is that deferred tax expense is defined as the change in the deferred tax asset and liability accounts occurring in the current period, and this change may encompass more than the mere effect of the current tax rate times the net temporary differences arising or being reversed in the present reporting period.

Although the primary objective of income tax accounting is no longer the proper matching of current period revenue and expenses, the once-critical matching principle retains some importance in financial reporting theory. Therefore, the tax effects of items excluded from profit and loss are also excluded from the profit and loss section of the statement of profit or loss and other comprehensive income. For example, the tax effects of items reported in other comprehensive income are likewise reported in other comprehensive income.

The recognition of income tax is based on the liability method. The liability method is statement of financial position-oriented. To understand the application of the liability method as incorporated in IAS 12, the basic recognition and measurement principles in IAS 12 must be understood, including how these recognition and measurement principles are applied to determine the current and deferred tax amounts.

## **RECOGNITION AND MEASUREMENT OF CURRENT TAX**

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### **Recognition of Current Tax**

The primary goal of the liability method is to present the estimated actual taxes to be payable in current and future periods as the income tax liability on the statement of financial position. Based on this goal, current tax for the current and prior periods is recognized as a liability to the extent it is unpaid at the end of the reporting period. If the amount paid exceeds the respective current tax recorded, an asset is recognized. The benefit of a tax loss that can be carried back to recover current tax of previous periods must also be recognized as an asset.

### **Measurement of Current Tax**

Current tax liabilities are measured at the amount expected to be paid to the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantially enacted by the end of the reporting period. Current tax assets are similarly measured at the amount expected to be recovered from the taxation authorities.

## **RECOGNITION AND MEASUREMENT OF DEFERRED TAX**

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### **Recognition of Deferred Tax**

The recognition of deferred tax is based on a statement of financial position orientation. Based on this orientation, deferred tax liabilities are recognized for taxable temporary

differences and deferred tax assets are recognized for deductible temporary differences, the carry forward of unused tax losses and the carry forward of unused tax credits.

The general principle is that a deferred tax liability is recognized for all taxable temporary differences. Two exceptions are, however, applicable. The first is temporary differences arising from the initial recognition of goodwill and the second is temporary differences arising from the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Deferred tax assets recognized for deductible temporary difference, the carry-forward of unused tax losses and the carry-forward of unused tax credits are subject to a probability limitation. Deferred tax is only recognized to the extent that it is probable that taxable profits are available against which the deductible temporary difference could be utilized. An exception, similar to a deferred tax liability, is also applicable to deductible temporary differences arising from the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Special principles are applicable to the recognition of temporary differences associated with investments in subsidiaries, branches and interest in joint ventures, which is discussed under Specific Transactions.

### **Measurement of Deferred Tax Assets**

Deferred tax assets and deferred tax liabilities are measured at the tax rates that are expected to apply to the period when the assets are realized or the liabilities are settled. The applicable tax rate is based on the tax rate (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

The computation of the amount of deferred taxes is based on the rate expected to be in effect when the temporary differences reverse. The annual computation is considered a tentative estimate of the liability (or asset) that is subject to change as the statutory tax rate changes or as the taxpayer moves into other tax rate brackets. The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow the manner in which management expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

The issue is that both the tax rate and the tax base of an asset or liability can be dependent on the manner in which the entity recovers or settles the asset or liability. An asset can either be recovered through usage or sale, or a combination. IAS 12 clarifies that the tax rate and tax base consistent with the expected manner of recovery or settlement must be used.

Special guidance is applicable to non-depreciable assets measured under the revaluation model and investment properties measured under the fair value model:

- Revalued non-depreciable assets are regarded to be recovered only through sale, since these assets are not depreciated. The tax rate and tax base that should be used is the one that would be applicable if the asset were sold at the end of the reporting period.
- A rebuttable presumption exists that investment properties carried at fair value will be recovered through sale. Deferred tax is thus created as if the entire investment property is recovered through sale at the end of the reporting period.

The presumption regarding investment properties is rebutted if the investment property is depreciated (for example buildings and leasehold land) and held within a business model

whose objective is to consume substantially all the economic benefits embodied in the investment property over time, rather than through sale. The presumption cannot be rebutted for freehold land, which is not depreciable. The rebuttable presumption is also applicable to investment properties measured at fair value in a business combination.

## RECOGNITION IN PROFIT OR LOSS

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The general principle is that all changes in current and deferred tax are recognized in profit or loss. Two exceptions are applicable. The first relates to transactions recognized in other comprehensive income. The current and deferred tax related to items recognized in other comprehensive income and equity should also be recognized in other comprehensive income and equity.

Secondly the initial deferred tax recognized on assets and liabilities acquired in a business combination are recognized as an adjustment to goodwill or any gain on a bargain purchase.

## CALCULATION OF DEFERRED TAX ASSET OR LIABILITY

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While conceptually the application of the liability method is straightforward, in the application of IAS 12 a number of complexities need to be addressed. The following process needs to be followed to calculate and measure deferred tax assets and liabilities:

1. Identification of temporary differences.
2. Identification of exceptions.
3. Identification of unused tax losses or tax credits.
4. Calculation and measurement of deferred tax assets or deferred tax liabilities.
5. Limitations on the recognition of deferred tax assets.

### Identification of Temporary Differences

The preponderance of the typical reporting entity's revenue and expense transactions are treated identically for tax and financial reporting purposes. Some transactions and events, however, will have different tax and accounting implications. In many of these cases, the difference relates to the period in which the income or expense will be recognized. Under earlier iterations of IAS 12, the latter differences were referred to as *timing differences* and were said to originate in one period and to reverse in a later period.

The current IAS 12 introduced the concept of *temporary differences*, which is a somewhat more comprehensive concept than that of timing differences. Temporary differences include all the categories of items defined under the earlier concept, and add a number of additional items, as well. Temporary differences are defined to include *all* differences between the carrying amount and the tax base of assets and liabilities.

$$\boxed{\begin{array}{|c|} \hline \text{Carrying} \\ \text{Value} \\ \hline \end{array}} - \boxed{\begin{array}{|c|} \hline \text{Tax Base} \\ \hline \end{array}} = \boxed{\begin{array}{|c|} \hline \text{Temporary} \\ \text{Difference} \\ \hline \end{array}}$$

The tax base of an asset or liability is defined as the amount attributable to that asset or liability for tax purposes. The following principles are included in IAS 12 to determine the tax base of assets and liabilities:

Element	Tax base
Asset	The amount that would be deductible for tax purposes when the carrying amount of the asset is recovered. If the economic benefits recovered from the asset are not taxable, the tax base of the asset is equal to its carrying amount.
Liability	The carrying amount less any amount that will be deductible for tax purposes in respect of the liability in future periods. In the case of revenue received in advance, the tax base is the carrying amount less any amount of the revenue that will not be taxed in future periods.

The tax base can also be determined for transactions not recognized in the statement of financial position. For example if an amount is expensed, but the amount is only deductible for tax purposes in the future, the tax base will be equal to the amount deductible in the future. When the tax base of an item is not immediately apparent, the following general principle of IAS 12 must be followed to determine the tax base:

Recognize a deferred tax asset when recovery or settlement of the carrying amount will reduce future taxable income and a deferred tax liability when the recovery or settlement of the carrying amount will increase future taxable income.

Once the tax base is determined the related temporary difference is calculated as the difference between carrying value and the tax base. Temporary differences are divided into taxable and deductible temporary differences. Taxable temporary differences represent a liability and are defined as temporary differences that will result in taxable amounts in determining taxable profits of future periods when the carrying amount of the asset or liability is recovered or settled. Deductible temporary differences represent an asset and are defined as temporary differences that will result in amounts that will be deductible in determining the taxable profits of future periods when the carrying amount of the asset or liability is recovered or settled.

Deductible and taxable temporary differences are thus based on the future taxable effect explained in the following examples:

1. **Revenue recognized for financial reporting purposes before being recognized for tax purposes.** Examples include revenue accounted for by the installment method for tax purposes, but reflected in income currently; certain construction-related revenue recognized on a completed-contract method for tax purposes, but on a percentage-of-completion basis for financial reporting; earnings from investees recognized by the equity method for accounting purposes but taxed only when later distributed as dividends to the investor. These are taxable temporary differences because the amounts are taxable in future periods, which give rise to deferred tax liabilities.
2. **Revenue recognized for tax purposes prior to recognition in the financial statements.** These include certain types of revenue received in advance, such as prepaid rental income and service contract revenue that is taxable when received. Referred to as deductible temporary differences, these items give rise to deferred tax assets.
3. **Expenses that are deductible for tax purposes prior to recognition in the financial statements.** This results when accelerated depreciation methods or shorter useful lives are used for tax purposes, while straight-line depreciation or longer useful economic lives are used for financial reporting; and when there are certain preoperating costs and certain capitalized interest costs that are deductible



currently for tax purposes. These items are taxable temporary differences and give rise to deferred tax liabilities.

4. **Expenses that are reported in the financial statements prior to becoming deductible for tax purposes.** Certain estimated expenses, such as warranty costs, as well as such contingent losses as accruals of litigation expenses, are not tax deductible until the obligation becomes fixed. These are deductible temporary differences, and accordingly give rise to deferred tax assets.

Other examples of temporary differences include:

1. **Reductions in tax-deductible asset bases arising in connection with tax credits.** Under tax provisions in certain jurisdictions, credits are available for certain qualifying investments in plant assets. In some cases, taxpayers are permitted a choice of either full accelerated depreciation coupled with a reduced investment tax credit, or a full investment tax credit coupled with reduced depreciation allowances. If the taxpayer chose the latter option, the asset basis is reduced for tax depreciation, but would still be fully depreciable for financial reporting purposes. Accordingly, this election would be accounted for as a taxable timing difference, and give rise to a deferred tax liability.
2. **Increases in the tax bases of assets resulting from the indexing of asset costs for the effects of inflation.** Occasionally, proposed and sometimes enacted by taxing jurisdictions, such a tax law provision allows taxpaying entities to finance the replacement of depreciable assets through depreciation based on current costs, as computed by the application of indices to the historical costs of the assets being remeasured. This revaluation of asset costs gives rise to deductible temporary differences that would be associated with deferred tax benefits.
3. **Certain business combinations accounted for by the acquisition method.** Under certain circumstances, the costs assignable to assets or liabilities acquired in purchase business combinations will differ from their tax bases. The usual scenario under which this arises is when the acquirer must continue to report the predecessor's tax bases for tax purposes, although the price paid was more or less than book value. Such differences may be either taxable or deductible and, accordingly, may give rise to deferred tax liabilities or assets. These are recognized as temporary differences by IAS 12.
4. **Assets that are revalued for financial reporting purposes although the tax bases are not affected.** This is analogous to the matter discussed in the preceding paragraph. Under certain IFRS (such as IAS 16 and IAS 40), assets may be upwardly adjusted to current fair values (revaluation amounts), although for tax purposes these adjustments are ignored until and unless the assets are disposed of. The discrepancies between the adjusted book carrying values and the tax bases are temporary differences under IAS 12, and deferred taxes are to be provided on these variations. This is required even if there is no intention to dispose of the assets in question, or if, under the salient tax laws, exchanges for other similar assets (or reinvestment of proceeds of sales in similar assets) would effect a postponement of the tax obligation.

### Identification of Exemptions

Two exemptions are applicable to the recognition of deferred tax, namely goodwill and initial recognition exception.

### ***Goodwill***

No deferred tax liability should be recognized on the initial recognition of goodwill. Although goodwill represents an asset, no deferred tax is considered to arise since goodwill is measured as a residual of the value of net assets acquired in a business combination. The deferred tax recognized on the acquired net assets of the business combination, however, affects the value of goodwill as the residual. IAS 12 also clarifies that no deferred tax effects are applicable to the later impairment of goodwill.

If goodwill or a gain on a bargain purchase is not deductible or taxable, respectively, in a given tax jurisdiction (that is, it is a permanent difference), in theory its tax base is zero, and thus there is a difference between tax and financial reporting bases, to which one would logically expect deferred taxes would be attributed. However, given the residual nature of goodwill or a gain on a bargain purchase, recognition of deferred taxes would in turn create yet more goodwill, and thus more deferred tax, etc. There would be little purpose achieved by loading up the statement of financial position with goodwill and related deferred tax in such circumstances, and the computation itself would be quite challenging. Accordingly, IAS 12 prohibits grossing up goodwill in such a fashion. Similarly, no deferred tax benefit will be computed and presented in connection with the financial reporting recognition of a gain on a bargain purchase.

However, IAS 12 states that if the carrying amount of goodwill under a business combination is less than its tax base, a deferred tax asset should be recognized. This will be in jurisdictions where future tax deductions are available for goodwill. The deferred tax assets will only be recognized to the extent that it is probable that future taxable profits will be available to utilize the deduction.

### ***Initial recognition exemption***

No deferred tax liability or asset is recognized on the initial recognition of an asset or liability that is not part of a business combination, and at the time of the transaction, affects neither accounting profit nor taxable profits. IAS 12, for example, states that an asset which is not depreciated for tax purposes, will be exempt under this initial recognition exemption, provided that any capital gain or loss on the disposal of the asset will also be exempt for tax purposes.

In some tax jurisdictions, the costs of certain assets are never deductible in computing taxable profit. For accounting purposes such assets may be subjected to depreciation or amortization. Thus, the asset in question has a differing accounting base than tax base and this results in a temporary difference. Similarly, certain liabilities may not be recognized for tax purposes resulting in a temporary difference. While IAS 12 accepts that these represent temporary differences a decision was made to not permit recognition of deferred tax on these. The reason given is that the new result would be to “gross up” the recorded amount of the asset or liability to offset the recorded deferred tax liability or benefit, and this would make the financial statements “less transparent.” It could also be argued that when an asset has, as one of its attributes, non-deductibility for tax purposes, the price paid for this asset would have been affected accordingly, so that any such “gross-up” would cause the asset to be reported at an amount in excess of fair value.

#### **Basic example of initial recognition example**

Johnson PLC purchases an intangible asset from Peters PLC. Johnson will not be entitled to any tax deductions on the intangible asset. The asset was purchased for \$1,000,000.

On day one, the temporary difference would be as follows:

Carrying value	1,000,000
Tax base	0
Temporary difference	<u>1,000,000</u>
Tax rate	20%
Deferred tax	200,000

Without this exemption, the journal entries on day one would be as follows:

Intangible asset	1,200,000
Bank	1,000,000
Deferred tax liability	200,000

As a result, the carrying value of the asset would also now be 1,200,000 and deferred tax would again be calculated to incorporate the increase in the asset's carrying value. This is a circular calculation which would eventually result in a carrying amount much higher than the purchase price. The initial recognition exemption criterion, therefore, requires no deferred tax to be recognized in this example.

### Identification of Unused Tax Losses or Tax Credits

Unused tax losses or unused tax credits must be identified to determine whether deferred tax assets should be recognized in such transactions.

### Calculation and Measurement of Deferred Tax Assets and Liabilities

The procedure to compute the gross deferred tax provision (i.e., before addressing whether the deferred tax asset is likely to be realized and therefore should be recognized) after exempt temporary differences and unused tax losses and tax credits are identified is as follows:

1. Segregate the temporary differences into those that are taxable and those that are deductible. This step is necessary because under IAS 12 only those deferred tax assets that are likely to be realized are recognized, whereas all deferred tax liabilities are given full recognition.
2. Accumulate information about the *deductible* temporary differences, particularly the net operating loss and credit carryforwards that have expiration dates or other types of limitations.
3. Measure the tax effect of aggregate *taxable* temporary differences by applying the appropriate expected tax rates (federal plus any state, local and foreign rates that are applicable under the circumstances).
4. Similarly, measure the tax effects of *deductible* temporary differences, including net operating loss carryforwards.

It should be emphasized that separate computations should be made for each tax jurisdiction, since in assessing the propriety of recording the tax effects of deductible temporary differences it is necessary to consider the entity's ability to absorb deferred tax assets against tax liabilities. Inasmuch as assets receivable from one tax jurisdiction will not reduce taxes payable to another jurisdiction, separate calculations will be needed. Also, for purposes of statement of financial position presentation (discussed below in detail), the offsetting of deferred tax assets and liabilities may be permissible only within jurisdictions, since there may not be a legal right to offset obligations due to and from different taxing

authorities. Similarly, separate computations should be made for each taxpaying component of the business. Thus, if a parent company and its subsidiaries are consolidated for financial reporting purposes but file separate tax returns, the reporting entity comprises a number of components, and the tax benefits of any one will be unavailable to reduce the tax obligations of the others.

The principles set forth above are illustrated by the following examples.

**Basic example of the computation of deferred tax liability and asset**

Assume that Noori Company has pre-tax financial income of €250,000 in 20XX-1, a total of €28,000 of taxable temporary differences, and a total of €8,000 of deductible temporary differences. Noori has no operating loss or tax credit carryforwards. The tax rate is a flat (i.e., not graduated) 40%. Also assume that there were no deferred tax liabilities or assets in prior years.

Taxable income is computed as follows:

Pre-tax financial income	€250,000
Taxable temporary differences	(28,000)
Deductible temporary differences	<u>8,000</u>
Taxable income	<u>€230,000</u>

The journal entry to record required amounts is:

Current income tax expense	92,000	
Deferred tax asset	3,200	
Income tax expense—deferred	8,000	
Deferred tax liability		11,200
Income taxes currently payable		92,000

Current income tax expense and income taxes currently payable are each computed as taxable income times the current rate (€230,000 × 40%). The deferred tax asset of €3,200 represents 40% of deductible temporary differences of €8,000. The deferred tax liability of €11,200 is calculated as 40% of taxable temporary differences of €28,000. The deferred tax expense of €8,000 is the *net* of the deferred tax liability of €11,200 and the deferred tax asset of €3,200.

In 20XX, Noori Company has pre-tax financial income of €450,000, aggregate taxable and deductible temporary differences are €75,000 and €36,000, respectively, and the tax rate remains a flat 40%. Taxable income is €411,000, computed as pre-tax financial income of €450,000 minus taxable differences of €75,000 plus deductible differences of €36,000. Current income tax expense and income taxes currently payable each are €164,400 (€411,000 × 40%).

Deferred amounts are calculated as follows:

	<i>Deferred tax liability</i>	<i>Deferred tax asset</i>	<i>Deferred tax expense</i>
Required balance at 12/31/XX			
€75,000 × 40%	€30,000		--
€36,000 × 40%		€14,400	--
Balances at 12/31/XX-1	<u>11,200</u>	<u>3,200</u>	--
Adjustment required	<u>€18,800</u>	<u>€11,200</u>	<u>€7,600</u>

The journal entry to record the deferred amounts is:

Deferred tax asset	11,200	
Income tax expense—deferred	7,600	
Deferred tax liability		18,800

Because the *increase* in the liability in 20XX is larger (by €7,600) than the increase in the asset for that year, the result is a deferred tax *expense* for 20XX.

### Limitation on the Recognition of Deferred Tax Assets

Although the case for presentation in the financial statements of any amount computed for deferred tax liabilities is clear, it can be argued that deferred tax assets should be included in the statement of financial position only if they are, in fact, very likely to be realized in future periods. Since realization will almost certainly be dependent on the future profitability of the reporting entity, it may become necessary to ascertain the likelihood that the enterprise will be profitable. Absent convincing evidence of that, the concepts of conservatism and realization would suggest that the asset be treated as a contingent gain, and not accorded recognition until and unless ultimately realized.

Under IAS 12, deferred tax assets resulting from temporary differences and from tax loss carryforwards are to be given recognition only if realization is deemed to be *probable*. To operationalize this concept, the standard sets forth several criteria, which variously apply to deferred tax assets arising from temporary differences and from tax loss carryforwards. The standard establishes that:

1. It is *probable* that future taxable profit will be available against which a deferred tax asset arising from a deductible temporary difference can be utilized when there are sufficient taxable temporary differences relating to the same taxation authority which will reverse either:
  - a. In the same period as the reversal of the deductible temporary difference; or
  - b. In periods into which the deferred tax asset can be carried back or forward; or
2. If there are insufficient taxable temporary differences relating to the same taxation authority, it is probable that the enterprise will have taxable profits in the same period as the reversal of the deductible temporary difference or in periods to which the deferred tax can be carried back or forward, or there are tax-planning opportunities available to the enterprise that will create taxable profit in appropriate periods.

Thus, there necessarily will be an element of judgement in making an assessment about how probable the realization of the deferred tax asset is, for those circumstances in which there is not an existing balance of deferred tax liability equal to or greater than the amount of the deferred tax asset. If it cannot be concluded that realization is probable, the deferred tax asset is not given recognition.

As a practical matter, there are a number of positive and negative factors which may be evaluated in reaching a conclusion as to amount of the deferred tax asset to be recognized. Positive factors (those suggesting that the full amount of the deferred tax asset associated with the gross temporary difference should be recorded) might include:

1. Evidence of sufficient future taxable income, exclusive of reversing temporary differences and carryforwards, to realize the benefit of the deferred tax asset.
2. Evidence of sufficient future taxable income arising from the reversals of existing taxable temporary differences (deferred tax liabilities) to realize the benefit of the tax asset.
3. Evidence of sufficient taxable income in prior year(s) available for realization of an operating loss carryback under existing statutory limitations.

4. Evidence of the existence of prudent, feasible tax planning strategies under management control that, if implemented, would permit the realization of the tax asset. These are discussed in greater detail below.
5. An excess of appreciated asset values over their tax bases, in an amount sufficient to realize the deferred tax asset. This can be thought of as a subset of the tax strategies idea, since a sale or sale/leaseback of appreciated property is one rather obvious tax-planning strategy to salvage a deferred tax benefit that might otherwise expire unused.
6. A strong earnings history exclusive of the loss that created the deferred tax asset. This would, under many circumstances, suggest that future profitability is likely and therefore that realization of deferred tax assets is probable.

Although the foregoing may suggest that the reporting entity will be able to realize the benefits of the deductible temporary differences outstanding as of the date of the statement of financial position, certain negative factors should also be considered in determining whether realization of the full amount of the deferred tax benefit is probable under the circumstances. These factors could include:

1. A cumulative recent history of accounting losses. Depending on extent and length of time over which losses were experienced, this could reduce the assessment of likelihood of realization below the important “probable” threshold.
2. A history of operating losses or of tax operating loss or credit carryforwards that have expired unused.
3. Losses that are anticipated in the near future years, despite a history of profitable operations.

Thus, the process of determining how much of the computed gross deferred tax benefit should be recognized involves the weighing of both positive and negative factors to determine whether, based on the preponderance of available evidence, it is probable that the deferred tax asset will be realized. IAS 12 notes that a history of unused tax losses should be considered “strong evidence” that future taxable profits might prove elusive. In such cases, it would be expected that primary reliance would be placed on the existence of taxable temporary differences that, upon reversal, would provide taxable income to absorb the deferred tax benefits that are candidates for recognition in the financial statements. In the absence of those taxable temporary differences, recognition would be much more difficult.

#### Example

To illustrate this computation in a more specific fact situation, assume the following facts:

1. Malpasa Corporation reports deferred tax under IAS 12. As of the December 31, 20XX statement of financial position, Malpasa has taxable temporary differences of €85,000 relating to depreciation, deductible temporary differences of €12,000 relating to deferred compensation arrangements, a net operating loss carryforward (which arose in 20XX-1) of €40,000, and a capital loss carryover of €10,000. Note that capital losses can only be offset against capital gains (not ordinary income), but may be carried forward until used.
2. Malpasa’s expected tax rate for future years is 40% for ordinary income, and 25% for net long-term capital gains.

The first steps are to compute the required balances of the deferred tax asset and liability accounts, without consideration of whether the tax asset would be probable of realization. The computations would proceed as follows:

<i>Deferred tax liability</i>	
Taxable temporary difference (depreciation)	€85,000
Effective tax rate	× 40%
Required balance	<b><u>€34,000</u></b>
<i>Deferred tax asset</i>	
Deductible temporary differences	€12,000
Deferred compensation	40,000
Net operating loss	€52,000
Effective tax rate	× 40%
Required balance (a)	<b><u>€20,800</u></b>
Capital loss	€10,000
Effective tax rate	× 25%
Required balance (b)	<b><u>€2,500</u></b>
<i>Total deferred tax asset</i>	
Ordinary (a)	€20,800
Capital (b)	<u>2,500</u>
Total required balance	<b><u>€23,300</u></b>

The next step would be to consider whether realization of the deferred tax asset is probable. Malpasa management must evaluate both positive and negative evidence to determine this matter. Assume now that management identifies the following factors that may be relevant:

1. Before the net operating loss deduction, Malpasa reported taxable income of €5,000 in 20XX. Management believes that taxable income in future years, apart from NOL deductions, should continue at about the same level experienced in 20XX.
2. The taxable temporary differences are not expected to reverse in the foreseeable future.
3. The capital loss arose in connection with a transaction of a type that is unlikely to recur. The company does not generally engage in activities that have the potential to result in capital gains or losses.
4. Management estimates that certain productive assets have a fair value exceeding their respective tax bases by about €30,000. The entire gain, if realized for tax purposes, would be a recapture of depreciation previously taken. Since the current plans call for a substantial upgrading of the company's plant assets, management feels that it could easily accelerate those actions to realize taxable gains, should it be desirable to do so for tax-planning purposes.

Based on the foregoing information, Malpasa Corporation management concludes that a €2,500 adjustment to deferred tax assets is required. The reasoning is as follows:

1. There will be some taxable operating income generated in future years (€5,000 annually, based on the earnings experienced in 20XX), which will absorb a modest portion of the reversal of the deductible temporary difference (€12,000) and net operating loss carryforward (€40,000) existing at year-end 20XX.
2. More important, the feasible tax planning strategy of accelerating the taxable gain relating to appreciated assets (€30,000) would certainly be sufficient, in conjunction with operating income over several years, to permit Malpasa to realize the tax benefits of the deductible temporary difference and NOL carryover.
3. However, since capital loss carryovers are only usable to offset future capital gains and Malpasa management is unable to project future realization of capital gains, the

associated tax benefit accrued (€2,500) will probably not be realized, and thus cannot be recognized.

Based on this analysis, deferred tax benefits in the amount of €20,800 should be recognized.

### ***Future temporary differences as a source for taxable profit to offset deductible differences***

In some instances, an entity may have deferred tax assets that will be realizable when future tax deductions are taken, but it cannot be concluded that there will be sufficient taxable profits to absorb these future deductions. However, the enterprise can reasonably predict that if it continues as a going concern, it will generate other temporary differences such that taxable (if not book) profits will be created. It has indeed been argued that the going concern assumption underlying much of accounting theory is sufficient rationale for the recognition of deferred tax assets in such circumstances.

However, IAS 12 makes it clear that this is not valid reasoning. The new taxable temporary differences anticipated for future periods will themselves reverse in even later periods; these cannot do “double duty” by also being projected to be available to absorb currently existing deductible temporary differences. Thus, in evaluating whether realization of currently outstanding deferred tax benefits is probable, it is appropriate to consider the currently outstanding taxable temporary differences, but not taxable temporary differences that are projected to be created in later periods.

### ***Tax-planning opportunities that will help realize deferred tax assets***

When an entity has deductible temporary differences and taxable temporary differences pertaining to the same tax jurisdiction, there is a presumption that realization of the relevant deferred tax assets is probable, since the relevant deferred tax liabilities should be available to offset these. However, before concluding that this is valid, it will be necessary to consider further the *timing* of the two sets of reversals. If the deductible temporary differences will reverse, say, in the very near term, and the taxable differences will not reverse for many years, it is a matter for concern that the tax benefits created by the former occurrence may expire unused prior to the latter event occurring. Thus, when the existence of deferred tax obligations serves as the logical basis for the recognition of deferred tax assets, it is also necessary to consider whether, under pertinent tax regulations, the benefit carryforward period is sufficient to assure that the benefit will not be lost to the reporting enterprise.

For example, if the deductible temporary difference is projected to reverse in two years but the taxable temporary difference is not anticipated to occur for another 10 years, and the tax jurisdiction in question offers only a five-year tax loss carryforward, then (absent other facts suggesting that the tax benefit is probable of realization) the deferred tax benefit could not be given recognition under IAS 12.

However, the entity might have certain tax-planning opportunities available to it, such that the pattern of taxable profits could be altered to make the deferred tax benefit, which might otherwise be lost, probable of realization. For example, again depending on the rules of the salient tax jurisdiction, an election might be made to tax interest income on an accrual rather than on a cash received basis, which might accelerate income recognition such that it would be available to offset or absorb the deductible temporary differences. Also, claimed tax deductions might be deferred to later periods, similarly boosting taxable profits in the short term.

More subtly, a reporting entity may have certain assets, such as buildings, which have appreciated in value. It is entirely feasible, in many situations, for an enterprise to take certain steps, such as selling the building to realize the taxable gain thereon and then either



leasing back the premises or acquiring another suitable building, to salvage the tax deduction that would otherwise be lost to it due to the expiration of a loss carryforward period. If such a strategy is deemed to be reasonably available, even if the entity does not expect to have to implement it (for example, because it expects other taxable temporary differences to be originated in the interim), it may be used to justify recognition of the deferred tax benefits.

Consider the following example of how an available tax planning strategy might be used to support recognition of a deferred tax asset that otherwise might have to go unrecognized.

**Example of the impact of a qualifying tax strategy**

Assume that Kirloski Company has a €180,000 operating loss carryforward as of December 31, 20XX-1, scheduled to expire at the end of the following year. Taxable temporary differences of €240,000 exist that are expected to reverse in approximately equal amounts of €80,000 in 20XX, 20XX+1 and 20XX+2. Kirloski Company estimates that taxable income for 20XX (exclusive of the reversal of existing temporary differences and the operating loss carryforward) will be €20,000. Kirloski Company expects to implement a qualifying tax planning strategy that will accelerate the total of €240,000 of taxable temporary differences to 20XX. Expenses to implement the strategy are estimated to approximate €30,000. The applicable expected tax rate is 40%.

In the absence of the tax planning strategy, €100,000 of the operating loss carryforward could be realized in 20XX based on estimated taxable income of €20,000 plus €80,000 of the reversal of taxable temporary differences. Thus, €80,000 would expire unused at the end of 20XX and the net amount of the deferred tax asset at 12/31/XX would be recognized at €40,000, computed as €72,000 (= €180,000 × 40%) minus the valuation allowance of €32,000 (€80,000 × 40%).

However, by implementing the tax planning strategy, the deferred tax asset is calculated as follows:

**Taxable income for 20XX**

Expected amount without reversal of taxable temporary differences	€ 20,000
Reversal of taxable temporary differences due to tax planning strategy, net of costs	210,000
	230,000
Operating loss to be carried forward	(180,000)
Operating loss expiring unused at 12/31/XX	<u>€ 0</u>

The deferred tax asset to be recorded at 12/31/15 is €54,000. This is computed as follows:

Full benefit of tax loss carryforward	
€180,000 × 40% =	€72,000
Less: Net-of-tax effect of anticipated expenses related to implementation of the strategy	
€30,000 – (€30,000 × 40%) =	18,000
Net	<u>€54,000</u>

Kirloski Company will also recognize a deferred tax liability of €96,000 at the end of 20XX (40% of the taxable temporary differences of €240,000).

***Subsequently revised expectations that a deferred tax benefit is realizable***

It may happen that, in a given reporting period, a deferred tax asset is deemed unlikely to be realized and accordingly is not recognized, but in a later reporting period the judgement is made that the amount is in fact realizable. If this change in expectation occurs, the deferred

tax asset previously not recognized will now be recorded. This does not constitute a prior period adjustment because no accounting error occurred. Rather, this is a change in estimate and is to be included in current earnings. Thus, the tax provision in the period when the estimate is revised will be affected.

Similarly, if a deferred tax benefit provision is made in a given reporting period, but later events suggest that the amount is, in whole or in part, not probable of being realized, the provision should be partially or completely reversed. Again, this adjustment will be included in the tax provision in the period in which the estimate is altered, since it is a change in an accounting estimate. Under either scenario the footnotes to the financial statements will need to provide sufficient information for the users to make meaningful interpretations, since the amount reported as tax expense will seemingly bear an unusual relationship to the reported pre-tax accounting profit for the period.

If the deferred tax provision in a given period is misstated due to a clerical error, such as miscalculation of the effective expected tax rate, this would constitute an accounting error, and this must be accounted for according to IAS 8's provisions; this standard requires restatement of prior period financial statements and does not permit adjusting opening retained earnings for the effect of the error. Errors are thus distinguished from changes in accounting estimate, as the latter are accounted for prospectively, without restatement of prior period financial statements. Correction of accounting errors is discussed in Chapter 7.

#### Example of determining the extent to which the deferred tax asset is realizable

Assume that Zacharias Corporation has a deductible temporary difference of €60,000 at December 31, 20XX. The applicable tax rate is a flat 40%. Based on available evidence, management of Zacharias Corporation concludes that it is probable that all sources will not result in future taxable income sufficient to realize more than €15,000 (i.e., 25%) of the deductible temporary difference. Also, assume that there were no deferred tax assets in previous years and that prior years' taxable income was inconsequential.

At 12/31/XX Zacharias Corporation records a deferred tax asset in the amount of €6,000 (= €60,000 × 25% × 40). The journal entry at 12/31/XX is:

Deferred tax asset	6,000	
Income tax benefit—deferred		6,000

The deferred income tax benefit of €6,000 represents the tax effect of that portion of the deferred tax asset (25%) that is probable of being realized.

## EFFECT OF CHANGED CIRCUMSTANCES

The carrying amount of deferred tax assets or liabilities may change when there is no change in the amount of the related temporary differences. Examples are tax rate or tax law changes, reassessment of the recoverability of deferred tax assets and changes in the expected manner of recovery of an asset. These changes are normally recognized in profit or loss as discussed below.

### Effect of Tax Law Changes on Previously Recorded Deferred Tax Assets and Liabilities

The statement of financial position-oriented measurement approach of IAS 12 necessitates the revaluation of the deferred tax asset and liability balances at each year-end. Although IAS 12 does not directly address the question of changes to tax rates or other provisions of the tax law (e.g., deductibility of items) which may be enacted that will affect

the realization of future deferred tax assets or liabilities, the effect of these changes should be reflected in the year-end deferred tax accounts in the period the changes are enacted. The offsetting adjustments should be made through the current period tax provision.

When revised tax rates are enacted, they may affect not only the unreversed effects of items which were originally reported in the continuing operations section of the statement of income (under revised IAS 1, the income statement section of a combined statement of profit or loss and other comprehensive income), but also the unreversed effects of items first presented as other comprehensive income. Although it might be conceptually superior to report the effects of tax law changes on such unreversed temporary differences in these same statements of profit or loss and other comprehensive income captions, as a practical matter the complexities of identifying the diverse treatments of these originating transactions or events would make such an approach unworkable. Accordingly, remeasurements of the effects of tax law changes should generally be reported in the tax provision associated with continuing operations.

#### **Example of the computation of a deferred tax asset with a change in rates**

Assume that the Fanuzzi Company has €80,000 of deductible temporary differences at the end of 20XX which are expected to result in tax deductions of approximately €40,000 each in 20XX+1 and thereafter. Enacted tax rates are 50% for the years 20XX-4 – 20XX, and 40% for 20XX+1 and thereafter.

The deferred tax asset is computed at December 31, 20XX, under each of the following independent assumptions:

1. If Fanuzzi Company expects to offset the deductible temporary differences against taxable income in the years 20XX+1 and thereafter, the deferred tax asset is €32,000 ( $€80,000 \times 40\%$ ).
2. If Fanuzzi Company expects to realize a tax benefit for the deductible temporary differences of an assessed loss, the deferred tax asset is €40,000 ( $= €80,000 \times 50\%$ ).

Changes in tax law may affect rates, and may also affect the taxability or deductibility of income or expense items. While the latter type of change occurs infrequently, the impact is similar to the more common tax rate changes.

#### **Example of effect of change in tax law**

Leipzig Corporation has, at December 31, 20XX-1, gross receivables of €12,000,000 and an allowance for bad debts in the amount of €600,000. Also assume that expected future taxes will be at a 40% rate. Effective January 1, 20XX, the tax law is revised to eliminate deductions for accrued bad debts, with existing allowances required to be taken into income over three years (a three-year spread). A statement of financial position of Leipzig Corporation prepared on January 1, 20XX would report a deferred tax benefit in the amount of €240,000 (i.e.,  $€600,000 \times 40\%$ , which is the tax effect of future deductions to be taken when specific receivables are written off and bad debts are incurred for tax purposes); a current tax liability of €80,000 (one-third of the tax obligation); and a non-current tax liability of €160,000 (two-thirds of the tax obligation). Under the requirements of IAS 12, the deferred tax benefit must be entirely reported as non-current in classified statements of financial position, inasmuch as no deferred tax benefits or obligations can be shown as current.

### **Reporting the Effect of Tax Status Changes**

Changes in the tax status of the reporting entity should be reported in a manner that is entirely analogous to the reporting of enacted tax law changes. When the tax status change

becomes effective, the consequent adjustments to deferred tax assets and liabilities are reported in current tax expense as part of the tax provision relating to continuing operations.

The most commonly encountered changes in status are those attendant to an election, where permitted, to be taxed as a partnership or other flow-through enterprise. (This means that the corporation will not be treated as a taxable entity but rather as an enterprise that “flows through” its taxable income to the owners on a current basis. This favourable tax treatment is available to encourage small businesses, and often will be limited to entities having sales revenue under a particular threshold level, or to entities having no more than a maximum number of shareholders.) Enterprises subject to such optional tax treatment may also request that a previous election be terminated. When a previously taxable corporation becomes a non-taxed corporation, the stockholders become personally liable for taxes on the company’s earnings, whether the earnings are distributed to them or not (similar to the relationship among a partnership and its partners).

As issued, IAS 12 did not explicitly address the matter of reporting the effects of a change in tax status, although the appropriate treatment was quite obvious given the underlying concepts of that standard. This ambiguity was subsequently resolved by the issuance of SIC 25, which stipulates that in most cases the current and deferred tax consequences of the change in tax status should be included in net profit or loss for the period in which the change in status occurs. The tax effects of a change in status are included in results of operations because a change in a reporting entity’s tax status (or that of its shareholders) does not give rise to increases or decreases in the pre-tax amounts recognized directly in equity.

The exception to the foregoing general rule arises in connection with those tax consequences which relate to transactions and events that result, in the same or a different period, in a direct credit or charge to the recognized amount of equity. For example, an event that is recognized directly in equity is a change in the carrying amount of property, plant or equipment revalued under IAS 16. Those tax consequences that relate to change in the recognized amount of equity, in the same or a different period (not included in net profit or loss) should be charged or credited directly to equity.

The most common situation giving rise to a change in tax status would be the election by a corporation, in those jurisdictions where it is permitted to do so, to be taxed as a partnership, trust or other flow-through entity. If a corporation having a net deferred tax liability elects non-taxed status, the deferred taxes will be eliminated through a credit to current period earnings. That is because what had been an obligation of the corporation has been eliminated (by being accepted directly by the shareholders, typically); a debt thus removed constitutes earnings for the formerly obligated party.

Similarly, if a previously non-taxed corporation becomes a taxable entity, the effect is to assume a net tax benefit or obligation for unreversed temporary differences existing at the date the change becomes effective. Accordingly, the financial statements for the period of such a change will report the effects of the event in the current tax provision. If the entity had at that date many taxable temporary differences as yet unreversed, it would report a large tax expense in that period. Conversely, if it had a large quantity of unreversed deductible temporary differences, a substantial deferred tax benefit (if probable of realization) would need to be recorded, with a concomitant credit to the current period’s tax provision in the statement of comprehensive income. Whether eliminating an existing deferred tax balance or recording an initial deferred tax asset or liability, the income tax note to the financial statements will need to fully explain the nature of the events that transpired.

In some jurisdictions, non-taxed corporation elections are automatically effective when filed. In such a case, if a reporting entity makes an election before the end of the current fiscal year, it is logical that the effects be reported in current year income to become effective at the start of the following period. For example, an election filed in December 20XX-1 would be reported in the 20XX-1 financial statements to become effective at the beginning of the company's next fiscal year, January 1, 20XX. No deferred tax assets or liabilities would appear on the December 31, 20XX-1 statement of financial position, and the tax provision for the year then ended would include the effects of any reversals that had previously been recorded. Practice varies, however, and in some instances the effect of the elimination of the deferred tax assets and liabilities would be reported in the year the election actually becomes effective.

### **Reporting the Effect of Accounting Changes Made for Tax Purposes**

Occasionally, an entity will initiate or be required to adopt changes in accounting that affect income tax reporting, but that will not impact on financial reporting. For example, in certain jurisdictions at varying times, the following changes have been mandated: use of the direct write-off method of bad debt recognition instead of providing an allowance for bad debts, while continuing to use the reserve method as required by GAAP for financial reporting; the "full costing" method of computing inventory valuations for tax purposes (adding some items that are administrative costs to overhead), while continuing to currently expense those costs not allowed to be capitalized into inventory under GAAP; and use of accelerated capital recovery (depreciation) methods for tax reporting while continuing to use normal methods for financial reporting. Often, these changes really involve two distinct temporary differences. The first of these is the onetime, catch-up adjustment which either immediately or over a prescribed time period affects the tax basis of the asset or liability in question (net receivables or inventory, in the examples above), and which then reverses as these assets or liabilities are later realized or settled and are eliminated from the statement of financial position. The second change is the ongoing differential in the amount of newly acquired assets or incurred liabilities being recognized for tax and accounting purposes; these differences also eventually reverse. This second type of change is the normal temporary difference which has already been discussed. It is the first change that differs from those previously discussed earlier in the chapter.

### **Implications of Changes in Tax Rates and Status Made in Interim Periods**

Tax rate changes may occur during an interim reporting period, either because a tax law change mandated a midyear effective date, or because tax law changes were effective at year-end but the reporting entity has adopted a fiscal year-end other than the natural year (December 31). The IFRS on interim reporting, IAS 34 (addressed in detail in Chapter 34), has essentially embraced a mixed view on interim reporting—with many aspects conforming to a "discrete" approach (each interim period standing on its own) but others, including accounting for income taxes, conforming to the "integral" manner of reporting. Whatever the philosophical strengths and weaknesses of the discrete and integral approaches in general, the integral approach was clearly warranted in the matter of accounting for income taxes.

The fact that income taxes are assessed annually is the primary reason for concluding that taxes are to be accrued based on an entity's estimated average annual effective tax rate for the full fiscal year. If rate changes have been enacted to take effect later in the fiscal year, the expected effective rate should take into account the rate changes as well as the anticipated

pattern of earnings to be experienced over the course of the year. Thus, the rate to be applied to interim period earnings (or losses, as discussed further below) will take into account the expected level of earnings for the entire forthcoming year, as well as the effect of enacted (or substantially enacted) changes in the tax rates to become operative later in the fiscal year. In other words, and as expressed by IAS 34, the estimated average annual rate would “reflect a blend of the progressive tax rate structure expected to be applicable to the full year’s earnings enacted or substantially enacted changes in the income tax rates scheduled to take effect later in the financial year.”

While the principle espoused by IAS 34 is both clear and logical, a number of practical issues can arise. The standard does address in detail the various computational aspects of an effective interim period tax rate, some of which are summarized in the following paragraphs.

Many modern business entities operate in numerous nations or states and therefore are subject to a multiplicity of taxing jurisdictions. In some instances the amount of income subject to tax will vary from one jurisdiction to the next, since the tax laws in different jurisdictions will include and exclude disparate items of income or expense from the tax base. For example, interest earned on government-issued bonds may be exempted from tax by the jurisdiction that issued them, but be defined as fully taxable by other tax jurisdictions the entity is subject to. To the extent feasible, the appropriate estimated average annual effective tax rate should be separately ascertained for each taxing jurisdiction and applied individually to the interim period pre-tax income of each jurisdiction, so that the most accurate estimate of income taxes can be developed at each interim reporting date. In general, an overall estimated effective tax rate will not be as satisfactory for this purpose as would a more carefully constructed set of estimated rates, since the pattern of taxable and deductible items will fluctuate from one period to the next.

Similarly, if the tax law prescribes different income tax rates for different categories of income, then to the extent practicable, a separate effective tax rate should be applied to each category of interim period pre-tax income. IAS 34, while mandating such detailed rules of computing and applying tax rates across jurisdictions or across categories of income, nonetheless recognized that such a degree of precision may not be achievable in all cases. Thus, IAS 34 allows usage of a weighted-average of rates across jurisdictions or across categories of income provided it is a reasonable approximation of the effect of using more specific rates.

In computing an expected effective tax rate given for a tax jurisdiction, all relevant features of the tax regulations should be taken into account. Jurisdictions may provide for tax credits based on new investment in plant and machinery, relocation of facilities to backward or underdeveloped areas, research and development expenditures, levels of export sales, and so forth, and the expected credits against the tax for the full year should be given consideration in the determination of an expected effective tax rate. Thus, the tax effect of new investment in plant and machinery, when the local taxing body offers an investment credit for qualifying investment in tangible productive assets, will be reflected in those interim periods of the fiscal year in which the new investment occurs (assuming it can be forecast to occur later in a given fiscal year), and not merely in the period in which the new investment occurs. This is consistent with the underlying concept that taxes are strictly an annual phenomenon, but it is at variance with the purely discrete view of interim financial reporting.

IAS 34 notes that, although tax credits and similar modifying elements are to be taken into account in developing the expected effective tax rate to apply to interim earnings, tax benefits that will relate to onetime events are to be reflected from the interim period when those events take place. This is perhaps most likely to be encountered in the context of capital gains taxes incurred in connection with occasional disposals of investments and other capital assets; since it is not feasible to project the timing of such transactions over the course of a year, the tax effects should be recognized only as the underlying events actually do transpire.

While in most cases tax credits are to be handled as suggested in the foregoing paragraphs, in some jurisdictions tax credits, particularly those that relate to export revenue or capital expenditures, are in effect government grants. Accounting for government grants is set forth in IAS 20; in brief, grants are recognized in income over the period necessary to properly match them to the costs which the grants are intended to offset or defray. Thus, compliance with both IAS 20 and IAS 34 would require that tax credits be carefully analysed to identify those which are in substance grants, and that credits are accounted for consistent with their true natures.

When an interim period loss gives rise to a tax loss carryback, it should be fully reflected in that interim period. Similarly, if a loss in an interim period produces a tax loss carryforward, it should be recognized immediately, but only if the criteria set forth in IAS 12 are met. Specifically, it must be deemed probable that the benefits will be realizable before the loss benefits can be given formal recognition in the financial statements. In the case of interim period losses, it may be necessary to assess not only whether the enterprise will be profitable enough in future fiscal years to utilize the tax benefits associated with the loss, but furthermore, whether interim periods later in the same year will provide earnings of sufficient magnitude to absorb the losses of the current period.

IAS 12 provides that changes in expectations regarding the realizability of benefits related to net operating loss carryforwards should be reflected currently in tax expense. Similarly, if a net operating loss carryforward benefit is not deemed probable of being realized until the interim (or annual) period when it in fact becomes realized, the tax effect will be included in tax expense of that period. Appropriate explanatory material must be included in the notes to the financial statements, even on an interim basis, to provide users with an understanding of the unusual relationship reported between pre-tax accounting income and the provision for income taxes.

## **SPECIFIC TRANSACTIONS**

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### **Income Tax Consequences of Dividends Paid**

Historically, some taxing jurisdictions have levied income taxes on corporate earnings at differential rates, depending on whether the earnings are retained by the entity or are distributed to shareholders. Typically, the rationale for this disparate treatment is that it motivates business entities to make distributions to shareholders, which is deemed a socially worthwhile goal by some (although it doesn't really alter wealth accumulation unless distortions are introduced by fiscal policy). A secondary reason for such rules is that this partially ameliorates the impact of the double taxation of corporate profits (which are typically first taxed at the corporate level, then taxed again as distributed to shareholders as taxable dividends).

Under the provisions of IAS 12, tax effects are to be provided for current taxable earnings without making any assumptions about future dividend declarations. In other words, the tax provision is to be computed using the tax rate applicable to undistributed earnings, even if the enterprise has a long history of making earnings distributions subsequent to year-end, which when made will generate tax savings. If dividends are later declared, the tax effect of this event will be accounted for in the period in which the proposed dividend is paid or becomes accruable as a liability by the enterprise, if earlier. Since there is typically no legal requirement to declare distributions to shareholders, this approach is clearly appropriate because to recognize tax benefits associated with dividend payments before declaration would be to anticipate income (in the form of tax benefits) before it is earned.

The standard holds that the tax effect of the dividend declaration (or payment) is to be included in the current period's tax provision, not as an adjustment to the earlier period's earnings, taken through the retained earnings account. This is true even when it is clear that the dividend is a distribution being made out of the earlier period's profits. The logic of this requirement is that the tax benefits are more closely linked to events reported in the statement of profit or loss and other comprehensive income (i.e., the past or current transactions producing net income) than they are to the dividend distribution. In other words, it is the transactions and events resulting in earnings and not the act of distributing some of these earnings to shareholders that is of the greatest pertinence to financial statement users.

If dividends are declared before the end of the year, but are payable after year-end, the dividends become a legal liability of the reporting entity and taxes should be computed at the appropriate rate on the amount thus declared. If the dividend is declared after year-end but before the financial statements are issued, under IAS 10 a liability cannot be recognized on the statement of financial position at year-end, and thus the tax effect related thereto also cannot be given recognition. Disclosure would be made, however, of this post-year-end event.

To illustrate the foregoing, consider the following example:

Amir Corporation operates in a jurisdiction where income taxes are payable at a higher rate on undistributed profits than on distributed earnings. For the year 20XX-1, the company's taxable income is €150,000. Amir also has net taxable temporary differences amounting to €50,000 for the year, thus creating the need for a deferred tax provision. The tax rate on distributed profits is 25%, and the rate on undistributed profits is 40%; the difference is refundable if profits are later distributed. As of the date of the statement of financial position no liability for dividends proposed or declared has been reflected on the statement of financial position. March 31, 20XX, however, the company distributes dividends of €50,000.

The tax consequences of dividends on undistributed profits, current and deferred taxes for the year 20XX-1, and the recovery of 20XX-1 income taxes when dividends are subsequently declared would be as follows:

1. Amir Corporation recognizes a current tax liability and a current tax expense for 20XX-1 of  $€150,000 \times 40\% = €60,000$ ;
2. No asset is recognized for the amount that will be (potentially) recoverable when dividends are distributed;
3. Deferred tax liability and deferred tax expense for 20XX-1 would be  $€50,000 \times 40\% = €20,000$ ; and



4. In the following year (20XX) when the company recognizes dividends of €50,000, the company will also recognize the recovery of income taxes of  $€50,000 \times (40\% - 25\%) = €7,500$  as a current tax asset and a reduction of the current income tax expense.

The only exception to the foregoing accounting for tax effects of dividends that are subject to differential tax rates arises in the situation of a dividend-paying corporation which is required to withhold taxes on the distribution and remit these to the taxing authorities. In general, withholding tax is offset against the amounts distributed to shareholders, and is later forwarded to the taxing bodies rather than to the shareholders, so that the total amount of the dividend declaration is not altered. However, if the corporation pays the tax in addition to the full amount of the dividend payments to shareholders, some might view this as a tax falling on the corporation and, accordingly, add this to the tax provision reported on the statement of comprehensive income. IAS 12, however, makes it clear that such an amount, if paid or payable to the taxing authorities, is to be charged to equity as part of the dividend declaration if it does not affect income taxes payable or recoverable by the enterprise in the same or a different period.

Finally, IAS 12 provides that disclosure will be required of the potential income tax consequences of dividends. The reporting enterprise should disclose the amounts of the potential income tax consequences that are practically determinable, and whether there are any potential income tax consequences not practically determinable.

### Accounting for Business Combinations at the Acquisition Date

When assets and liabilities are valued at fair value, as required under IFRS 3, but the tax base is not adjusted (i.e., there is a carryforward basis for tax purposes), there will be differences between the tax and financial reporting bases of these assets and liabilities, which will constitute temporary differences. Deferred tax assets and liabilities need to be recognized for these differences as an adjustment to goodwill or the bargain purchase gain. The most common example of this is where taxes are calculated at a subsidiary level in a group, and when these items are consolidated into the group accounts, there are consolidation adjustments to the carrying amounts of the assets which result in additional temporary differences at group level.

The limitation on the recognition of deferred tax assets is also applicable to business combinations.

#### Example of temporary differences in business acquisition

An example, in the context of the business acquisition of Windlass Corp., follows:

1. The income tax rate is a flat 40%.
2. The acquisition of a business is effected at a cost of €500,000.
3. The fair values of assets acquired total €750,000.
4. The carryforward tax bases of assets acquired total €600,000.
5. The fair and carryforward tax bases of the liabilities assumed in the purchase are €250,000.
6. The difference between the tax and fair values of the assets acquired, €150,000, consists of taxable temporary differences of €200,000 and deductible temporary differences of €50,000.
7. There is no doubt as to the realizability of the deductible temporary differences in this case.

Based on the foregoing facts, allocation of the purchase price is as follows:

Gross purchase price	€ <u>500,000</u>
Allocation to identifiable assets and (liabilities):	
Assets acquired	750,000
Deferred tax asset (€50,000 * 40%).	20,000
Liabilities acquired,	(250,000)
Deferred tax liability (€200,000 * 40%)	(80,000)
Net of the above allocations	<u>440,000</u>
Goodwill	€ <u>60,000</u>

### Accounting for Purchase Business Combinations after the Acquisition

Under the provisions of IAS 12, net deferred tax benefits are not to be carried forward as assets unless the deferred tax assets are deemed *probable* of being realized. The assessment of this probability was discussed earlier in the chapter.

In the above example (Windlass), it was specified that all deductible temporary differences were fully realizable, and therefore the deferred tax benefits associated with those temporary differences were recorded as of the acquisition date. In other situations there may be substantial doubt concerning realizability; that is, it may not be probable that the benefits will be realized. Accordingly, under IAS 12, the deferred tax asset would not be recognized at the date of the business acquisition. If so, the allocation of the purchase price would have to reflect that fact, and more of the purchase cost would be allocated to goodwill than would otherwise be the case.

If, at a later date, it is determined that some of or the entire deferred tax asset that was not recognized at the date of the acquisition is, in fact, probable of being ultimately realized, the effect of that re-evaluation will reduce the carrying amount of goodwill. If the carrying amount of goodwill is reduced to nil, any remaining deferred tax asset will be recognized in the tax expense in profit or loss. If a bargain purchase price gain was recognized initially, the deferred tax asset adjustment must be recorded in profit or loss.

#### Example of revising estimate of tax benefit realizability in business combination

To illustrate this last concept, assume that a business acquisition occurs on January 1, 20XX-2, and that deferred tax assets of €100,000 are *not* recognized at that time, due to an assessment that realization is not probable. The unrecognized tax asset is implicitly allocated to goodwill during the purchase price assignment process. On January 1, 20XX, the likelihood of ultimately realizing the tax benefit is reassessed as being probable, with realization projected for later years. The balance of goodwill on January 1, 20XX, was €80,000. The entries at that date are as follows:

Deferred tax asset	100,000	
Goodwill		80,000
Profit and loss		20,000

A related issue is that the probability of realizing a pre-acquisition deferred tax asset of the acquirer could change due to the business combination. For instance the acquirer has an unrecognized deferred tax loss that would in the future be recoverable from income receivable from the acquired subsidiary. The acquirer recognizes the change in the deferred tax asset in the period of the acquisition, but cannot include it in the accounting of the business combination, and therefore in the determining of the goodwill or bargain purchase

gain of the business combination. This is because the unrecognized deferred tax is not a transaction of the acquiree.

### **Temporary Differences in Consolidated Financial Statements**

Temporary differences in consolidated financial statements are determined by comparing the consolidated carrying values of assets and liabilities with the relevant tax base. The tax base is determined by reference to the applicable tax regime. If the entity is taxed on a group base, the tax base is the group tax base. However, if each entity in the group is taxed separately, the tax base is determined with reference to each individual entity. In the latter case, additional deferred tax can arise that is only recognized in the consolidated financial statements.

### **Assets Carried at Fair Value**

IFRS allows certain assets to be recognized at fair value or at revalued amounts. If the revaluation or adjustment to the fair value affects the taxable profit immediately, the tax base is also adjusted and no deferred tax would be recognized. Examples include derivatives recognized at fair value for both accounting and tax purposes. However, if the revaluation or restatement to fair value does not affect the taxable profit immediately, deferred tax must be created on the revaluation. The tax base of the asset is not adjusted. The difference between the adjusted carrying value and the tax base is a temporary difference. The normal principles regarding the recovery of the assets through use or sale will be applicable to determine the amount of the related deferred tax. It should be noted that IAS 12 has specific provisions relating to the recognition of deferred tax on revalued assets (under IAS 16) and investment properties at fair value (under IAS 40). For these assets, IAS 12 has a presumption that the assets will be recovered through sale. As a result, any deferred tax raised on the revalued or fair valued assets is done so at the rate applicable on sale. This presumption can be rebutted should the entity be able to prove that it consumes substantially all the asset through use, and that the asset is a depreciable asset, in which case it can use the use rate to raise deferred tax. What this means in practice is that should an entity rebut the presumption, it would need to split the deferred tax into that relating to the land and that relating to the building. The deferred tax on the land will always be raised at the sale rate as it is not a depreciable asset, whereas the deferred tax relating to the building would be raised at the use rate. This split can prove difficult in practice, which is why most entities elect to use the sale rate for all temporary differences arising on revalued and fair valued buildings.

### **Tax on Investments in Subsidiaries, Associates and Joint Ventures**

In terms of the general rule deferred tax should also be recognized on investments in subsidiaries, associates and joint ventures similar to other assets. In an important exception to the general rule, IAS 12 provides that when the parent, investor or joint venturer can prevent the taxable event from occurring, deferred taxes are not recognized. Specifically, under IAS 12, two conditions must *both* be satisfied to justify *not* reflecting deferred taxes in connection with the earnings of a subsidiary (a control situation), branches and associates (significant influence) and joint ventures. These are (1) that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and (2) it is probable that the difference will not reverse in the foreseeable future. Unless *both* conditions are met, the tax effects of these temporary differences must be given recognition.

When a parent company that has the ability to control the dividend and other policies of its subsidiary determines that dividends will not be declared, and thus that the undistributed profit of the subsidiary will not be taxed at the parent company level, no deferred tax liability is to be recognized. If this intention is later altered, the tax effect of this change in estimate would be reflected in the current period's tax provision.

On the other hand, an investor, even one having significant influence, cannot absolutely determine the associate's dividend policy. Accordingly, it has to be presumed that earnings will eventually be distributed and that these will create taxable income at the investor company level. Therefore, deferred tax liability must be provided for the reporting entity's share of all undistributed earnings of its associates for which it is accounting by the equity method, unless there is a binding agreement for the earnings of the investee to not be distributed within the foreseeable future.

In the case of joint ventures there are a wide range of possible relationships between the venturers, and in some cases the reporting entity has the ability to control the payment of dividends. As in the foregoing, if the reporting entity has the ability to exercise this level of control and it is probable that distributions will not be made within the foreseeable future, no deferred tax liability will be reported.

In all these various circumstances, it will be necessary to assess whether distributions within the foreseeable future are probable. The standard does not define "foreseeable future" and thus this will remain a matter of subjective judgement. The criteria of IAS 12, while subjective, are less ambiguous than under the original standard, which permitted non-recognition of deferred tax liability when it was "reasonable to assume that (the associate's) profits will not be distributed."

#### Example of tax allocation for investee and subsidiary income

To illustrate the application of these concepts, assume that Parent Company owns 30% of the outstanding ordinary shares of an Associate Company and 70% of the ordinary shares of a Subsidiary Company. Additional data for the year 20XX are as follows:

	<u>Associate Company</u>	<u>Subsidiary Company</u>
Net income	€50,000	€100,000
Dividends paid	20,000	60,000

How the foregoing data are used to recognize the tax effects of the stated events is discussed below.

**Investment in associate company.** The investment in the associate company will be equity accounted. The equity income capitalized will be after the dividend received. The investments in the associate will thus increase with €9,000 ( $30\% \times (\text{€}50,000 - \text{€}20,000)$ ). Deferred tax needs to be created on the increase of the investment of €9,000. The increase in the carrying amount could be recovered through dividends or through the ultimate sale of the associate. Dividend income might be taxed at a different rate than the capital gains on the sale of the associate. Assume that only 20% of the dividend is subject to tax of 34% and the capital gains tax rate is also 34%. Based on recovery through dividends the deferred tax will be €612 ( $20\% \times 34\% \times \text{€}9,000$ ). Based on the recovery through sale the deferred tax will be €3,060 ( $34\% \times \text{€}9,000$ ).

**Investment in subsidiary company.** Normally an investment in a subsidiary company will be recorded at cost in the records of the parent company. No deferred tax will therefore be recognized. However, if the option is followed to fair value the investment, deferred tax must be created using the appropriate rate of recovery of the investment, unless the exception to the general rule applies.

However, in the consolidated financial statements the investment in the subsidiary will be replaced by the assets and liabilities. Therefore any deferred tax created on the investment in the subsidiary company in the parents' own financial statements should also be reversed.

### Tax Effects of Compound Financial Instruments

IAS 32 established the important notion that when financial instruments are compound, the separately identifiable components are to be accounted for according to their distinct natures. For example, when an entity issues convertible debt instruments, those instruments may have characteristics of both debt and equity securities, and accordingly, the issuance proceeds should be allocated among those components. (IAS 32 requires that the full fair value of the liability component be recognized, with only the residual allocated to equity, consistent with the concept that equity is only the residual interest in an entity.) A problem arises when the taxing authorities do not agree that a portion of the proceeds should be allocated to a secondary instrument. IAS 12 requires that deferred tax must be created on both the liability and equity component. The deferred tax on the equity component should be recognized direct in equity.

#### Example of tax effects of compound financial instrument at issuance

Consider the following scenario. Tamara Corp. issues 6% convertible bonds with a face value of €3,000,000, due in 10 years, with the bonds being convertible into Tamara ordinary shares at the holders' option. Proceeds of the offering amount to €3,200,000, for an effective yield of approximately 5.13% at a time when "straight" debt with similar risks and time to maturity is yielding just less than 6.95% in the market. Since the fair value of the debt component is thus €2.8 million out of the actual proceeds of €3.2 million, the convertibility feature is seemingly worth €400,000 in the financial marketplace. Under revised IAS 32, the full fair value of the liability component must be allocated to it, with only the residual value being attributed to equity.

The entry to record the issuance of the bonds follows:

Cash	3,200,000	
Unamortized debt discount	200,000	
Debt payable		3,000,000
Equity portion of bond		400,000

Deferred tax is created on both the carrying amount of the equity and liability component.

#### Example of tax effects of compound financial instrument in subsequent periods

To illustrate, continue the preceding example and assume that the tax rate is 30%, and for simplicity, also assume that the debt discount will be amortized on a straight-line basis over the 10-year term ( $€200,000 \div 10 = €20,000$  per year), although in theory amortization using the "effective yield" method is preferred. The tax effect of the total debt discount is  $€200,000 \times 30\% = €60,000$ . Annual interest expense is  $€20,000 + (€3,000,000 \times 6\%) = €200,000$ . The entries to establish deferred tax liability accounting at inception, and to reflect interest accrual and reversal of the deferred tax account are as follows:

*At inception (in addition to the entry shown above)*

Equity portion of bond	60,000	
Deferred tax liability		60,000

*Each year thereafter*

Interest expense	200,000	
Interest payable		180,000
Unamortized debt discount		20,000
Deferred tax liability	6,000	
Tax expense—deferred		6,000

Note that the offset to deferred tax liability at inception is a charge to equity, in effect reducing the credit to the portion of the bond recognized in equity of the compound financial instrument to a net-of-tax basis, since allocating a portion of the proceeds to the equity component caused the creation of a non-deductible deferred charge, debt discount. When the deferred charge is later amortized, however, the reversing of the temporary difference leads to a reduction in tax expense to better “match” the higher interest expense reported in the financial statements than on the tax return.

### Share-Based Payment Transactions

Share-based payment transactions are similar to other transactions subject to deferred tax if the carrying amount differs from the tax base. For example, the expense for the share options granted as compensations is recognized over the vesting period of the share options. For tax purposes assume the amount is only deducted when the options are granted; the tax base will be the expense recognized in equity that is only deducted for tax in future periods. A deferred tax asset is created for the amount that is deducted in the future.

## PRESENTATION AND DISCLOSURE

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### Presentation

Somewhat surprisingly, IAS 12 stated that should the reporting entity classify its statement of financial position (into current and non-current assets and liabilities), deferred tax assets and liabilities should never be included in the current category. All deferred tax balances are always classified as non-current.

Current tax and deferred tax assets and liabilities may only be offset if specific criteria are met. Current tax assets and current tax liabilities may only be offset if:

- The entity has a legally enforceable right to offset the recognized amounts; and
- The entity intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Current tax assets and current tax liabilities of different entities can also only be offset if the above offsetting rules apply, which would be rare, except if the group is taxed on a consolidated basis.

Deferred tax assets and deferred tax liabilities are only offset if:

- The entity has a legal enforceable right to set off current tax assets and current tax liabilities; and
- The deferred tax asset and deferred tax liabilities relate to income levied by the same tax authority on the same tax entity or different entities which intend either to settle current tax assets and liabilities on a net basis or simultaneously, in each future period when significant deferred tax assets or liabilities are expected to be recovered or settled.

## Disclosures

Revised IAS 12 mandated a number of disclosures, including some that had not been required under earlier practice. The purpose of these disclosures is to provide the user with an understanding of the relationship between pre-tax accounting profit and the related tax effects, as well as to aid in predicting future cash inflows or outflows related to tax effects of assets and liabilities already reflected in the statement of financial position. The more recently imposed disclosures were intended to provide greater insight into the relationship between deferred tax assets and liabilities recognized, the related tax expense or benefit recognized in earnings, and the underlying natures of the related temporary differences resulting in those items. There is also enhanced disclosure for discontinued operations under IAS 12. Finally, when deferred tax assets are given recognition under defined conditions, there will be disclosure of the nature of the evidence supporting recognition. The specific disclosures are presented in greater detail in the following paragraphs.

### *Statement of financial position disclosures*

A reporting entity is required to disclose the amount of a deferred tax asset and the nature of evidence supporting its recognition, when:

1. Utilization of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of the existing taxable temporary differences; *and*
2. The enterprise has suffered a loss in the same tax jurisdiction to which the deferred tax assets relate in either the current or preceding period.

### *Statement of profit or loss and other comprehensive income disclosures*

IAS 12 places primary emphasis on disclosure of the components of income tax expense or benefit. The following information must be disclosed about the components of tax expense for each year for which a statement of profit or loss and other comprehensive income is presented.

The components of tax expense or benefit, which may include some or all of the following:

1. Current tax expense or benefit.
2. Any adjustments recognized in the current period for taxes of prior periods.
3. The amount of deferred tax expense or benefit relating to the origination and reversal of temporary differences.
4. The amount of deferred tax expense or benefit relating to changes in tax rates or the imposition of new taxes.
5. The amount of the tax benefit arising from a previously unrecognized tax loss, tax credit or temporary difference of a prior period that is used to reduce current period tax expense.
6. The amount of the tax benefit from a previously unrecognized tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense.
7. Deferred tax expense arising from the write-down of a deferred tax asset because it is no longer deemed probable of realization.
8. The amount of tax expense relating to changes in accounting policies and errors that cannot be accounted for retrospectively.

In addition to the foregoing, IAS 12 requires that disclosures be made of the following items which are to be separately stated:

1. The aggregate current and deferred tax relating to items that are charged or credited to equity.
2. The amount of income tax related to each component of other comprehensive income.
3. The relationship between tax expense or benefit and accounting profit or loss either (or both) as:
  - a. A numerical reconciliation between tax expense or benefit and the product of accounting profit or loss times the applicable tax rate(s), with disclosure of how the rate(s) was determined; or
  - b. A numerical reconciliation between the average effective tax rate and applicable rate, also with disclosure of how the applicable rate was determined.
4. An explanation of changes in the applicable rate vs. the prior reporting period.
5. The amount and date of expiration of unrecognized tax assets relating to deductible temporary differences, tax losses and tax credits.
6. The aggregate amount of any temporary differences relating to investments in subsidiaries, branches, and associates and interests in joint ventures for which deferred liabilities have not been recognized.
7. For each type of temporary difference, including unused tax losses and credits, disclosure of:
  - a. The amount of the deferred tax assets and liabilities included in each statement of financial position presented; and
  - b. The amount of deferred income or expense recognized in the statement of comprehensive income, if not otherwise apparent from changes in the statements of financial position.
8. Disclosure of the tax expense or benefit related to discontinued operations.
9. Amount of income tax consequences of dividends proposed or declared before the authorization of the financial statement not recognized as a liability.
10. Changes in the preacquisition deferred tax assets of the acquirer of a business combination due to the incorporation of the business acquired.
11. Deferred tax assets of a business combination recognized after the acquisition date with a description of the event or change in circumstances.

Disclosure must be made of the amount of deferred tax asset and the evidence supporting its presentation in the statement of financial position, when both these conditions exist: utilization is dependent upon future profitability beyond that assured by the future reversal of taxable temporary differences, *and* the entity has suffered a loss in either the current period or the preceding period in the jurisdiction to which the deferred tax asset relates.

The nature of potential income tax consequences related to the payments of dividends must also be disclosed.



## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES

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**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

**Accounting policy note: taxation**

Income tax for the period is based on the taxable income for the year. Taxable income differs from profit as reported in the statement of comprehensive income for the period as there are some items which may never be taxable or deductible for tax and other items which may be deductible or taxable in other periods. Income tax for the period is calculated using the current ruling tax rate.

Deferred tax is the future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities shown on the statement of financial position. Deferred tax assets and liabilities are not recognized if they arise in the following situations: the initial recognition of goodwill; or the initial recognition of assets and liabilities that affect neither accounting nor taxable profit. The amount of deferred tax provided is based on the expected manner of recovery or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the statement of financial position date.

The group does not recognize deferred tax liabilities, or deferred tax assets, on temporary differences associated with investments in subsidiaries, joint ventures and associates where the parent company is able to control of the timing of the reversal of the temporary differences and it is not considered probable that the temporary differences will reverse in the foreseeable future. It is the group's policy to reinvest undistributed profits arising in group companies.

A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. The carrying amount of the deferred tax assets are reviewed at each statement of financial position date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the asset to be recovered.

**Income tax expense note**

	20XX	20XX-1	
UK corporation tax	X	X	IAS12 p79
Utilization of assessed losses not previously recognized	X	X	
Foreign tax	X	X	
	X	X	
	X	X	
Deferred tax			IAS12 p79
Current year	X	X	
Change in tax rate	X	X	
Total tax expense	X	X	
	X	X	
	X	X	

Corporation tax is calculated at X% (20XX-1: X%) of the estimated assessable profit for the IAS12 year. IAS12 p81

The tax expense for the year can be reconciled to the profit for the year as follows: IAS12 p81

	20XX	20XX-1
Profit before tax	X	X
Tax thereon at X% (20XX-1:X%)	X	X
Share of profit from associates and joint ventures	X	X
Non-deductible expenses	X	X
Utilization of assessed loss not previously recognized	X	X
Change in tax rate	X	X
Foreign tax expensed at lower rates than (country of domicile) standard rate	X	X
Total tax expense	X	X
	<u>X</u>	<u>X</u>

*(Alternative)*

IAS12 p81

The tax rate can be reconciled to the effective tax rate as follows:

	20XX	20XX-1
	%	%
Tax rate	X	X
Share of profit from associates and joint ventures	X	X
Non-deductible expenses	X	X
Utilization of assessed loss not previously recognized	X	X
Change in tax rate	X	X
Foreign tax expensed at lower rates than (country of domicile) standard rate	X	X
Total effective tax rate	X	X
	<u>X</u>	<u>X</u>

Deferred tax relating to the revaluation of available-for-sale financial assets of £ X (20XX-1: £ X) has been recognized directly in equity. IAS12 p81

**Deferred tax note**

	20XX	20XX-1
Deferred tax assets	X	X
Deferred tax liabilities	X	X
Net deferred tax liability	X	X
	<u>X</u>	<u>X</u>
Deferred tax assets comprise:		
Unused tax losses	X	X
Retirement benefit obligations	X	X
	<u>X</u>	<u>X</u>

IAS12 p81

Deferred tax liabilities comprise:			IAS12 p81
Accelerated capital allowances	X	X	
Fair value gains	X	X	
	<u>X</u>	<u>X</u>	

At the statement of financial position date the aggregate amount of temporary differences associated with investments in subsidiaries for which deferred tax liabilities have not been recognized was £ X (20XX-1: £ X). Deferred tax has not been raised in the statement of financial position as the group is in a position to control the timing of the reversal of these temporary differences and it is probable that such differences will not reverse in the foreseeable future. IAS12 p81

Deferred tax assets	Unused tax losses	Retirement benefit obligations	Total
Balance at 1 January 20XX-1	X	X	X
Recognized in the statement of comprehensive income	X	X	X
Recognized directly in equity	X	X	X
Balance at 1 January 20XX	X	X	X
Recognized in the statement of comprehensive income	X	X	X
Recognized directly in equity	X	X	X
<b>Balance at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>

Deferred income tax assets are recognized to the extent that the realization of the related tax benefit through future taxable profits are probable. Deferred tax assets of £X (20XX-1: £X) have not been recognized in respect of losses amounting to £X (20XX-1: £X) that can be carried forward against future taxable income. The unrecognized tax credits amounting to £X (20XX-1: £X) will expire in 20XX+2 and 20XX+1 respectively. IAS12 p81(e)

Deferred tax liabilities:	Capital allowances	Fair value gains	Total
Balance at 1 January 20XX-1	X	X	X
Recognized in the statement of comprehensive income	X	-	X
Recognized directly in equity		X	
Balance at 1 January 20XX	X	X	X
Recognized in the statement of comprehensive income	X	-	X
Recognized directly in equity	-	X	-
<b>Balance at 31 December 20XX</b>	<b>X</b>	<b>X</b>	<b>X</b>

### Proposed Amendments

The IASB proposed to amend IAS 12 to clarify the accounting for deferred tax assets for unrealized losses on debt instruments measured at fair value that will also be applied to other assets. This proposed amendment has been re-exposed during 2014 to clarify the application and is currently still under redeliberation.

## US GAAP COMPARISON

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US GAAP and IFRS record deferred taxes using the asset and liability approach. However, there are several differences:

- GAAP classifies deferred taxes as current or non-current based on the underlying asset or liability.
- Under US GAAP, a deferred tax asset is recognized in full and is then reduced by a valuation account if it is more likely than not that all or some of the asset will not be realized. The valuation allowance is revised upward or downward in future periods as the tax rates, probabilities of recovery, or characterization of tax attributes change.
- US GAAP uses the enacted tax rate.
- US GAAP requires entities to assess whether uncertain tax positions will be upheld under audit on the assumption that the tax examiner has access to all relevant information. If the position is more likely than not to be disallowed, potential liabilities must be accrued using a weighted probability method for the amount that has a minimum cumulative probability over 50% of being assessed by the tax jurisdiction in question. Consequently, an accrual for an uncertain tax position may vary significantly between IFRS and US GAAP. Additionally, a roll forward of uncertain tax positions is required. An entity must also disclose a description of tax years that remain subject to examination by major tax jurisdictions. Another disclosure for uncertain tax positions is the total amounts of interest and penalties recognized in the statement of operations and the statement of financial position.
- US GAAP does not require recognition of deferred taxes for investments in a foreign subsidiary or corporate joint venture that is essentially permanent in duration, unless it is apparent that the difference will reverse in the future.
- US GAAP requires deferral of taxes paid on intercompany profits and does not allow the recognition of deferred taxes on temporary differences between the tax bases of assets transferred that remain within the consolidation group.
- When graduated rates are significant elements in an entity's tax calculation, both IFRS and US GAAP require factoring this into the applied rate. US GAAP specifically directs users to use the rate applicable to the average income for the years projected.
- Presentation of income tax expense attributable to operations within a period (e.g., a quarter) is specifically defined under US GAAP to be income from continuing operations multiplied by the effective tax rate. Allocation of remaining income tax expense is then prorated to other elements of comprehensive income (e.g., discontinuing operations, foreign currency translation adjustments in equity). Changes in rates from prior-year tax positions are explicitly to be included in income from continuing operations regardless of the original financial statement characterization.

dilutive securities, there would be a great risk of misleading current shareholders regarding their claim to future earnings of the reporting entity.

### Sources of IFRS

IAS 33

## SCOPE

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IAS 33 states that the standard's applicability is both to entities whose ordinary shares or potential ordinary shares are publicly traded, and those entities that are in the process of issuing ordinary shares or potential ordinary shares in public securities markets. IAS 33 defines the point in the share issuance process when these requirements become effective as the point when the consideration is receivable.

Some private entities wish to report a statistical measure of performance, and often choose to use EPS. While these entities are not required to issue EPS data, when they elect to do so they must also comply with the requirements of IAS 33.

In situations when both parent company and consolidated financial statements are presented, IAS 33 stipulates that the information called for by this standard need only be presented for consolidated information. The reason for this rule is that users of financial statements of a parent company are interested in the results of operations of the group as a whole, as opposed to the parent company on a stand-alone basis. Of course, nothing prevents the entity from also presenting the parent-only information, including EPS, should it choose to do so. Again, the requirements of IAS 33 would have to be met by those making such an election.

Entities should present both basic EPS and diluted EPS in the statement of profit or loss and other comprehensive income or in the statement of profit or loss, if presented separately, for each class of ordinary shares that has a different right to share in profit or loss for the period. Equal prominence should be given to both the basic EPS and diluted EPS figures for all periods presented.

An entity that reports a discontinued operation shall disclose the basic EPS and diluted EPS for the discontinued operation either in the statement of profit or loss and other comprehensive income or in the notes.

Entities should present basic EPS and diluted EPS even if the amounts disclosed are negative. In other words, the standard mandates disclosure of not just *earnings per share*, but even *loss per share* figures.

## DEFINITIONS OF TERMS

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A number of terms used in a discussion of earnings per share have special meanings in that context. When used, they are intended to have the meanings given in the following definitions.

**Antidilution.** An increase in earnings per share or reduction in loss per share, resulting from the inclusion of potentially dilutive securities, in EPS calculations. The assumption is that convertible securities are converted, options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

**Basic earnings per share.** The amount of profit or loss for the period that is attributable to each ordinary share that is outstanding during all or part of the period.

**Call price.** The amount at which a security may be redeemed by the issuer at the issuer's option.

**Contingently issuable ordinary shares issuance.** A possible issuance of ordinary shares, for little or no cash or other consideration, that is dependent on the satisfaction of certain conditions set forth in a contingent share agreement.

**Conversion price.** The price that determines the number of ordinary shares into which a security is convertible. For example, €100 face value of debt convertible into five ordinary shares would be stated to have a conversion price of €20.

**Conversion rate.** The ratio of the number of ordinary shares issuable on conversion to a unit of convertible security. For example, a preference share may be convertible at the rate of three ordinary shares for each preference share.

**Conversion value.** The current market value of the ordinary shares obtainable on conversion of a convertible security, after deducting any cash payment required on conversion.

**Diluted earnings per share.** The amount of net profit for the period per share, reflecting the maximum dilutions that would have resulted from conversions, exercises and other contingent issuances that individually would have decreased earnings per share and in the aggregate would have had a dilutive effect.

**Dilution.** A reduction in earnings per share or an increase in net loss per share, resulting from the assumption that convertible securities have been converted and/or that options and warrants have been exercised, or other contingent shares have been issued on the fulfillment of certain conditions. Securities that would cause such earnings dilution are referred to as dilutive securities.

**Dual presentation.** The presentation with equal prominence of two different earnings per share amounts in the statement of profit or loss and comprehensive income: One is basic earnings per share; the other is diluted earnings per share.

**Earnings per share.** The amount of earnings (profit or loss) for a period attributable to each ordinary share (common share). It should be used without qualifying language (e.g., diluted) only when no potentially dilutive convertible securities, options, warrants or other agreements providing for contingent issuances of ordinary shares are outstanding.

**Exercise price.** The amount that must be paid for an ordinary share on exercise of a share option or warrant.

**If-converted method.** A method of computing earnings per share data that assumes conversion of convertible securities as of the beginning of the earliest period reported (or at time of issuance, if later). This method was mandated under US GAAP and can be analogized to IFRS when appropriate.

**Option.** The right to purchase ordinary shares in accordance with an agreement upon payment of a specified amount including, but not limited to, options granted to and share purchase agreements entered into with employees.

**Ordinary shares.** Those shares that are subordinate to all other shares of the issuer. Also known as common shares. Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated. An entity may have more than one class of ordinary shares; ordinary shares of the same class have the same rights as to dividends.

**Potential ordinary shares.** A financial instrument or other contract which could result in the issuance of ordinary shares to the holder. Examples include convertible debt or preferred shares, warrants, options and employee share purchase plans.

**Put option (on ordinary shares).** Contract which gives the holder the right to sell ordinary shares held, at a specified price, usually for a limited stipulated time period.

**Redemption price.** The amount at which a security is required to be redeemed at maturity or under a sinking-fund arrangement.

**Time of issuance.** In general, the date when agreement as to terms of share issuance has been reached and announced, even though such agreement is subject to certain further actions, such as directors' or shareholders' approval.

**Treasury share method.** A method of recognizing the use of proceeds that would be obtained on exercise of options and warrants in computing earnings per share. It assumes that any proceeds would be used to purchase ordinary shares at the average market price.

**Warrant.** A security giving the holder the right to purchase ordinary shares in accordance with the terms of the instrument, usually on payment of a specified amount.

**Weighted-average number of shares.** The number of shares determined by relating the portion of time within a reporting period that a particular number of shares of a certain security has been outstanding to the total time in that period. For example, if 100 shares of a certain security were outstanding during the first quarter of a fiscal year and 300 shares were outstanding during the balance of the year, the weighted-average number of outstanding shares would be  $250[(100 \times 1/4) + (300 \times 3/4)]$ .

## CONCEPTS, RULES AND EXAMPLES

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### Simple Capital Structure

A simple capital structure may be said to exist either when the capital structure consists solely of ordinary shares or when it includes no potential ordinary shares, which could be in the form of options, warrants, or other rights, that on conversion or exercise could, in the aggregate, dilute earnings per share. Dilutive securities are essentially those that exhibit the rights of debt or other senior security holders (including warrants and options) and which have the potential on their issuance to reduce the earnings per share.

### *Computational guidelines*

In its simplest form, the EPS calculation is profit or loss divided by the weighted-average number of ordinary shares outstanding. The objective of the EPS calculation is to determine the amount of earnings attributable to each ordinary share. Complexities arise because profit or loss does not necessarily represent the earnings available to the ordinary equity holder, and a simple weighted-average of ordinary shares outstanding does not necessarily reflect the true nature of the situation. Adjustments can take the form of manipulations of the numerator or of the denominator of the formula used to compute EPS, as discussed in the following paragraphs.

### *Numerator*

The profit or loss figure used as the numerator in any of EPS computations must exclude any claims against it by holders of senior securities. The justification for this reduction is that the claims of the senior securities must be satisfied before any income is available to the ordinary shareholder. These senior securities are usually in the form of preference shares, and the deduction from profit or loss is the amount of the dividend declared during the year on the preference shares. If the preference shares are cumulative, the dividend is to be deducted from profit (or added to the loss), whether it is declared or not. If preference shares do not have a cumulative right to dividends and current period dividends have been omitted, such dividends should not be deducted in computing EPS. Cumulative dividends in arrears that are paid currently do not affect the calculation of EPS in the current period, since such dividends have already been considered in prior periods' EPS computations. However, the amount in arrears should be disclosed, as should all of the other effects of the rights given to senior securities on the EPS calculation.

There may be various complications resulting from the existence, issuance or redemption of preferred shares. Thus, if "increasing rate" preferred shares are outstanding—where

contractually the dividend rate is lower in early years and higher in later years—the amount of preferred dividends in the early years must be adjusted in order to accrete the value of later, increased dividends, using an effective yield method akin to that used to amortize bond discount. If a premium is paid to preferred shareholders to retire the shares during the reporting period, this payment is treated as additional preferred dividends paid for purposes of EPS computations. Similarly, if a premium is paid (in cash or in terms of improved conversion terms) to encourage the conversion of convertible preferred shares, that payment (including the fair value of additional ordinary shares granted as an inducement) is included in the preferred dividends paid in the reporting period, thereby reducing earnings allocable to ordinary shares for EPS calculation purposes. Contrariwise, if preferred shares are redeemed at a value lower than carrying (book) amount—admittedly, not a very likely occurrence—that amount is used to reduce earnings available for ordinary equity holders in the period, thereby increasing EPS.

### ***Denominator***

The weighted-average number of ordinary shares outstanding is used so that the effect of increases or decreases in outstanding shares on EPS data is related to the portion of the period during which the related consideration affected operations. The difficulty in computing the weighted-average exists because of the effect that various transactions have on the computation of ordinary shares outstanding. Although it is impossible to analyse all the possibilities, the following discussion presents some of the more common transactions affecting the number of ordinary shares outstanding. The theoretical construct set forth in these relatively simple examples can be followed in all other situations.

If a company reacquires its own shares in countries where it is legally permissible to do so, the number of shares reacquired (referred to as treasury shares) should be excluded from EPS calculations from the date of acquisition. The same computational approach holds for the issuance of ordinary shares during the period. The number of shares newly issued is included in the computation only for the period after their issuance date. The logic for this treatment is that since the consideration for the shares was not available to the reporting entity, and hence could not contribute to the generation of earnings, until the shares were issued, the shares should not be included in the EPS computation prior to issuance. This same logic applies to the reacquired shares because the consideration expended in the repurchase of those shares was no longer available to generate earnings after the reacquisition date.

A share dividend (bonus issue) or a share split does not generate additional resources or consideration, but it does increase the number of shares outstanding. The increase in shares as a result of a share split or dividend, or the decrease in shares as a result of a reverse split, should be given retroactive recognition for all periods presented. Thus, even if a share dividend or split occurs at the end of the period, it is considered effective for the entire period of each (i.e., current and historical) period presented. The reasoning is that a share dividend or split has no effect on the ownership percentage of ordinary shares, and likewise has no impact on the resources available for productive investment by the reporting entity. As such, to show a dilution in the EPS in the period of the split or dividend would erroneously give the impression of a decline in profitability when in fact it was merely an increase in the shares outstanding due to the share dividend or split. Furthermore, financial statement users' frame of reference is the number of shares outstanding at the end of the reporting period, including shares resulting from the split or dividend, and using this in computing all periods' EPS serves to most effectively communicate to them.

IAS 33 carries this logic one step further by requiring the disclosure of pro forma (adjusted) amounts of basic and diluted earnings per share for the period in case of issue of shares with no



corresponding change in resources (e.g., share dividends or splits) occurring *after* the end of the reporting period, *but before* the issuance of the financial statements. The reason given is that the non-disclosure of such transactions would affect the ability of the users of the financial statements to make proper evaluations and decisions. It is to be noted, however, that the EPS numbers as presented in the statement of profit or loss and other comprehensive income are not required by IAS 33 to be retroactively adjusted because such transactions do not reflect the amount of capital used to produce the net profit or loss for the period.

Complications also arise when a business combination occurs during the period. In a combination accounted for as an acquisition (the only method allowable since IFRS 3 eliminated the pooling of interests method), the shares issued in connection with a business combination are considered issued and outstanding as of the date of acquisition and the income of the acquired company is included only for the period after acquisition.

IAS 33 recognizes that in certain countries it is permissible for ordinary shares to be issued in partly paid form, and the standard accordingly stipulates that partly paid instruments should be included as ordinary share equivalents to the extent to which they carry rights (during the financial reporting year) to participate in dividends in the same manner as fully paid shares.

Further, in the case of contingently issuable shares (i.e., ordinary shares issuable on fulfillment of certain conditions, such as achieving a certain level of profits or sales), IAS 33 requires that such shares be considered outstanding and included in the computation of basic earnings per share only when all these required conditions have been satisfied.

IAS 33 gives examples of situations where ordinary shares may be issued, or the number of shares outstanding may be reduced, without causing corresponding changes in resources of the corporation. Such examples include bonus issues, a bonus element in other issues such as a rights issue (to existing shareholders), a share split, a reverse share split and a capital reduction without a corresponding refund of capital. In all such cases the number of ordinary shares outstanding before the event is adjusted, as if the event had occurred at the beginning of the earliest period reported. For instance, in a “5-for-4 bonus issue” the number of shares outstanding prior to the issue is multiplied by a factor of 1.25. These and other situations are summarized in the tabular list that follows.

<b>Weighted-Average (WIA) Computation</b>	
<u>Transaction</u>	<u>Effect on WIA computation</u>
Ordinary shares outstanding at the beginning of the period	Increase number of shares outstanding by the number of shares
Issuance of ordinary shares during the period	Increase number of shares outstanding by the number of shares issued weighted by the portion of the year the ordinary shares are outstanding
Conversion into ordinary shares	Increase number of shares outstanding by the number of shares converted weighted by the portion of the year shares are outstanding
Company reacquires its shares	Decrease number of shares outstanding by number of shares reacquired times portion of the year outstanding
Share dividend or split	Increase number of shares outstanding by number of shares issued or increased due to the split
Reverse split	Decrease number of shares outstanding by decrease in shares
Acquisition	Increase number of shares outstanding by number of shares issued weighted by the portion of year since the date of acquisition

Rights offerings are used to raise additional capital from existing shareholders. These involve the granting of rights in proportion to the number of shares owned by each shareholder (e.g., one right for each 100 shares held). The right gives the holder the opportunity to purchase a share at a discounted value, as an inducement to invest further in the entity, and in recognition of the fact that, generally, rights offerings are less costly as a means of floating more shares, versus open market transactions which involve fees to brokers. In the case of rights shares, the number of ordinary shares to be used in calculating basic EPS is the number of ordinary shares outstanding prior to the issue, multiplied by the following factor:

$$\frac{\text{Fair value immediately prior to the exercise of the rights}}{\text{Theoretical ex-rights fair value}}$$

There are several ways to compute the theoretical value of the shares on an ex-rights basis. IAS 33 suggests that this be derived by adding the aggregate fair value of the shares immediately prior to exercise of the rights to the proceeds from the exercise, and dividing the total by the number of shares outstanding after exercise.

To illustrate, consider that the entity currently has 10,000 shares outstanding, with a market value of €15 per share, when it offers each holder rights to acquire one new share at €10 for each four shares held. The theoretical value ex-rights would be given as follows:

$$\frac{(10,000 \times €15) + (2,500 \times €10)}{12,500} = \frac{€175,000}{12,500} = €14$$

Thus, the ex-rights value of the ordinary shares is €14 each.

The foregoing do not characterize all possible complexities arising in the EPS computation; however, most of the others occur under a complex structure which is considered in the following section of this chapter. The illustration below applies the foregoing concepts to a simple capital structure.

#### Example of EPS computation—Simple capital structure

Assume the following information:

<u>Numerator information</u>		<u>Denominator information</u>	
a. Profit from continuing operations	€130,000	a. Ordinary shares outstanding January 1, 20XX	100,000
b. Loss on discontinued operations	30,000	b. Shares issued for cash April 1, 20XX	20,000
c. Profit for the year	100,000	c. Shares issued in 10% share dividend declared in July 20XX	12,000
d. 6% cumulative preference shares, €100 par, 1,000 shares issued and outstanding	100,000	d. Treasury shares purchased October 1, 20XX	10,000

When calculating the numerator, the claims of senior securities (i.e., preference shares) should be deducted to arrive at the earnings attributable to ordinary equity holders. In this example the preference shares are cumulative. Thus, regardless of whether or not the board of directors declares a preference dividend, holders of the preference shares have a claim of €6,000 (1,000 shares × €100 × 6%) against 20XX earnings. Therefore, €6,000 must be deducted from the numerator to arrive at profit or loss attributable to the owners of ordinary shares.

Note that any cumulative preference dividends in arrears are ignored in computing this period's EPS since they would have been incorporated into previous periods' EPS calculations. Also note that this €6,000 would have been deducted for non-cumulative preferred only if a dividend of this amount had been declared during the period. The EPS calculations for the foregoing fact pattern follow:

#### Earnings per ordinary share

$$\begin{aligned} \text{On profit from continuing operations} &= (\text{€130,000} - \text{€6,000} &= & \text{€1.00} \\ &\text{preference dividends}) \div \text{Weighted number of ordinary} \\ &\text{shares outstanding (see below)} \\ \text{On profit for the year} &= (\text{€130,000} - \text{€30,000} - \text{€6,000}) \div &= & \text{€0.76} \\ &\text{Weighted number of ordinary shares outstanding (see below)} \end{aligned}$$

Only the EPS amounts relating to the parent company, in the case of consolidated (group) financial statements, must be provided.

The computation of the denominator is based on the weighted-average number of ordinary shares outstanding. Recall that use of a simple average (e.g., the sum of year-beginning and year-end outstanding shares, divided by two) is not considered appropriate because it fails to accurately give effect to various complexities. The table below illustrates one way of computing the weighted-average number of shares outstanding. Note that, had share issuances occurred mid-month, the weighted-average number of shares would have been based on the number of days elapsing between events.

<i>Item</i>	<i>Number of shares actually outstanding</i>	<i>Fraction of the year outstanding</i>	<i>Shares times fraction of the year</i>
Number of shares as of beginning of the year January 1, 20XX	110,000 [100,000 + 10%(100,000)]	12/12	110,000
Shares issued April 1, 20XX	22,000 [20,000 + 10% (20,000)]	9/12	16,500
Treasury shares purchased October 1, 20XX	(10,000)	3/12	<u>(2,500)</u>
			<b><u>124,000</u></b>

Recall that the share dividend declared in July is considered to be retroactive to the beginning of the year. Thus, for the period January 1, 20XX through April 1, 20XX, 110,000 shares are considered to be outstanding. When shares are issued, they are included in the weighted-average beginning with the date of issuance. The share dividend applicable to these newly issued shares is also assumed to have existed for the same period. Thus, we can see that of the 12,000 share dividend, 10,000 shares relate to the beginning balance and 2,000 shares to the new issuance (10% of 100,000 and 20,000, respectively). The purchase of the treasury shares requires that these shares be excluded from the calculation for the remainder of the period after their acquisition date. The figure is subtracted from the calculation because the shares were purchased from those outstanding prior to acquisition. To complete the example, we divided the previously derived numerator by the weighted-average number of ordinary shares outstanding to arrive at EPS, which is [(€100,000 - €6,000) ÷ 124,000 =] €0.76.

Reporting a €0.24 loss per share (€30,000 ÷ 124,000) due to the discontinued operations is optional. The numbers computed above for the EPS based on profit for the year are the only presentation required in the statement of profit or loss and other comprehensive income (or separate statement of profit or loss, if presented).

### Complex Capital Structure

The computation of EPS under a complex capital structure involves all of the complexities discussed under the simple structure and many more. By definition, a complex capital

structure is one that has dilutive potential ordinary shares, which are shares or other instruments that have the potential to be converted or exercised and thereby reduce EPS. The effects of any antidilutive potential ordinary shares (those that would increase EPS) are not to be included in the computation of diluted earnings per share. Thus, diluted EPS can never provide a more favourable impression of financial performance than does the basic EPS.

Note that a complex structure requires dual presentation of both basic EPS and diluted EPS even when the basic earnings per share is a loss per share. Under the current standard, both basic and diluted EPS must be presented, unless diluted EPS would be antidilutive.

For the purposes of calculating diluted EPS, the profit or loss attributable to ordinary equity holders and the weighted-average number of ordinary shares outstanding should be adjusted for the effects of the dilutive potential ordinary shares. That is, the presumption is that the dilutive securities have been converted or exercised, with ordinary shares being outstanding for the entire period, and with the effects of the dilution removed from earnings (e.g., interest or dividends). In removing the effects of dilutive securities that in fact were outstanding during the period, the associated tax effects must also be eliminated, and all consequent changes—such as employee profit-sharing contributions that are based on reported profit or loss—must similarly be adjusted.

According to IAS 33, the numerator, representing the profit or loss attributable to the ordinary equity holders for the period, should be adjusted by the after-tax effect, if any, of the following items:

1. Interest recognized in the period for the convertible debt which constitutes dilutive potential ordinary shares;
2. Any dividends recognized in the period for the convertible preferred shares which constitute dilutive potential ordinary shares, where those dividends have been deducted in arriving at net profit attributable to ordinary equity holders; and
3. Any other, consequential changes in profit or loss that would result from the conversion of the dilutive potential ordinary shares.

For example, the conversion of debentures into ordinary shares will reduce interest expense which in turn will cause an increase in the profit for the period. This will have a consequential effect on contributions based on the profit figure, for example, the employer's contribution to an employee profit-sharing plan. The effect of such consequential changes on profit or loss available for ordinary equity holders should be considered in the computation of the numerator of the diluted EPS ratio.

The denominator, which has the weighted number of ordinary shares, should be adjusted (increased) by the weighted-average number of ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

#### **Example**

To illustrate, consider Chelsea Corporation, which has 100,000 shares of ordinary shares outstanding the entire period. It also has convertible debentures outstanding, on which interest of €30,000 was paid during the year. The debentures are convertible into 100,000 shares. Profit after tax (effective rate is 30%) amounts to €15,000, which is net of an employee profit-sharing contribution of €10,000, determined as 40% of after-tax income. Basic EPS is  $€15,000 \div 100,000$

shares = €0.15. Diluted EPS assumes that the debentures were converted at the beginning of the year, thereby averting €30,000 of interest which, after tax effect, would add €21,000 to net results for the year. Conversion also would add 100,000 shares, for a total of 200,000 shares outstanding. Furthermore, had operating results been boosted by the €21,000 of avoided after-tax interest cost, the employee profit sharing would have increased by  $€21,000 \times 40\% = €8,400$ , producing net results for the year of  $€15,000 + €21,000 - €8,400 = €27,600$ . Diluted EPS is thus  $€27,600 \div 200,000 = €0.138$ . Since this is truly dilutive, IFRS requires presentation of this amount.

### Determining Dilution Effects

In the foregoing example, the assumed conversion of the convertible debentures proved to be dilutive. If it had been *antidilutive*, presentation of the (more favourable) diluted EPS would not be permitted under IFRS. To ascertain whether the effect would be dilutive or antidilutive, each potential ordinary share issue (i.e., each convertible debenture, convertible preferred, or other issuance outstanding having distinct terms) must be evaluated separately from other potential ordinary share issuances. Since the interactions among potential ordinary share issues might cause diluted EPS to be moderated under certain circumstances, it is important that each issue be considered in the order of decreasing effect on dilution. In other words, the most dilutive of the potential ordinary share issues must be dealt with first, then the next most dilutive, and so on.

Potential ordinary shares are generally deemed to have been outstanding ordinary shares for the entire reporting period. However, if the potential shares were only first issued, or became expired or were otherwise cancelled during the reporting period, then the related ordinary shares are deemed to have been outstanding for only a portion of the reporting period. Similarly, if potential share are exercised during the period, then for that part of the year the actual shares outstanding are included for purposes of determining basic EPS, and the potential (i.e., unexercised) shares are used in the determination of diluted EPS by deeming these to have been exercised or converted for only that fraction of the year before the exercise occurred.

### Options and warrants

The exercise of options and warrants results in proceeds being received by the reporting entity. If actual exercise occurs, of course, the entity has resources which it will, logically, put to productive use, thereby increasing earnings to be enjoyed by ordinary equity holders (both those previously existing and those resulting from exercising their options and warrants). However, the presumed exercise for purposes of diluted EPS computations does not invoke actual resources being received, and earnings are not enhanced as they might have been in the case of actual exercise. If this fact were not dealt with, diluted EPS would be unrealistically depressed since the number of assumed shares would be increased but earnings would reflect the lower, actual level of investment being utilized by the entity.

IFRS prescribes the use of the “treasury share method” to deal with the hypothetical proceeds from the presumed option and warrant exercises. This method assumes that the proceeds from the option and warrant exercises would have been used to repurchase outstanding shares, at the average prevailing market price during the reporting period. This assumed repurchase of shares eliminates the need to speculate as to what productive use the hypothetical proceeds from option and warrant exercise would be put, and also reduces the assumed number of outstanding shares for diluted EPS calculation.

### Treasury Share (Stock) Method

Denominator must be increased by net dilution, as follows:

$$\text{Net dilution} = \text{Shares issued} - \text{Shares repurchased}$$

where

$$\text{Shares issued} = \text{Proceeds received} / \text{Exercise price}$$

$$\text{Shares repurchased} = \text{Proceeds received} / \text{Average market price per share}$$

IAS 33's way of expressing the required use of the "treasury share/stock method" is as follows: "The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration."

### Example

Assume the reporting entity issued 1,000 ordinary shares to option holders who exercised their rights and paid €15,000 to the entity. During the reporting period, the average price of ordinary shares was €25. Using the proceeds of €15,000 to acquire shares at a per share cost of €25 would have resulted in the purchase of 600 shares. Thus, a net of 400 additional shares would be assumed outstanding for the year, at no net consideration to or from the entity.

In all cases where the exercise price is lower than the market price, assumed exercise will be dilutive and some portion of the shares will be deemed issued for no consideration. If the exercise price is greater than the average market price, the exercise should not be assumed since the result of this would be antidilutive.

### *Convertible instruments*

Convertible instruments are assumed to be converted when the effect is dilutive. Convertible preferred shares will be dilutive if the preferred dividend declared (or, if cumulative, accumulated) in the current period is lower than the computed basic EPS. If the contrary situation exists, the impact of assumed conversion would be antidilutive, which is not permitted by IFRS.

Similarly, convertible debt is dilutive, and thus assumed to have been converted, if the after-tax interest, including any discount or premium amortization, is lower than the computed basic EPS. If the contrary situation exists, the assumption of conversion would be antidilutive, and thus not to be taken into account for diluted EPS computations.

While the term "if converted" is not explicitly employed by IAS 33, the methodology of the if-converted method is used for those securities that are currently sharing in the earnings of the company through the receipt of interest or dividends as senior securities but have the potential for sharing in the earnings as ordinary shares. The if-converted method logically recognizes that the convertible security can only share in the earnings of the company as one or the other, not as both. Thus, the dividends or interest less tax effects applicable to the convertible security as a senior security are not recognized in the profit or loss figure used to compute EPS, and the weighted-average number of shares is adjusted to reflect the conversion as of the beginning of the year (or date of issuance, if later). See the example of the if-converted method for illustration of treatment of convertible securities when they are issued during the period and therefore were not outstanding for the entire year.

<b>Example of the if-converted method</b>
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Assume a net profit for the year of €50,000 and a weighted-average number of ordinary shares outstanding of 10,000. The following information is provided regarding the capital structure:

1. 7% convertible debt, 200 bonds each convertible into 40 ordinary shares. The bonds were issued at par (€1,000 per bond). The bonds were outstanding the entire year. The income tax rate is 40%. No bonds were converted during the year.
2. 4% convertible, cumulative preferred shares, par €100, 1,000 shares issued and outstanding. Each preferred share is convertible into 2 ordinary shares. The preferred shares were issued at par and were outstanding the entire year. No shares were converted during the year.

The first step is to compute the basic EPS, that is, assuming only the issued and outstanding ordinary shares. This figure is simply computed as €4.60 (€50,000 – €4,000 preferred dividends) ÷ (10,000 ordinary shares outstanding). The diluted EPS must be less than this amount for a dual presentation of EPS to be necessary.

To determine the dilutive effect of the preferred shares an assumption (generally referred to as the if-converted method) is made that all of the preferred shares are converted at the earliest date that it could have been during the year. In this example, the date would be January 1. (If the preferred had been first issued during the year, the earliest date conversion could have occurred would have been the issuance date.) The effects of this assumption are twofold: (1) if the preferred is converted, there will be no preferred dividends of €4,000 for the year; and (2) there will be an additional 2,000 ordinary shares outstanding during the year (the conversion rate is 2 for 1 on 1,000 shares of preferred). Diluted EPS is computed, as follows, reflecting these two assumptions:

$$\frac{\text{Net profit for the year}}{\text{Weighted-average of ordinary shares outstanding} + \frac{\text{Shares issued upon conversion of preferred}}{12,000 \text{ shares}}} = \frac{€50,000}{12,000 \text{ shares}} = €4.17$$

The convertible preferred is dilutive because it reduced EPS from €4.60 to €4.17. Accordingly, a dual presentation of EPS is required.

In the example, the convertible bonds are also assumed to have been converted at the beginning of the year. Again, the effects of the assumption are twofold: (1) if the bonds are converted, there will be no interest expense of €14,000 (7% × €200,000 face value), the net effect of not having interest expense of €14,000 is €8,400 [(1 – 0.40) × €14,000], and (2) there will be an additional 8,000 shares (200 bonds × 40 shares) of ordinary shares outstanding during the year. Diluted EPS is computed as follows, reflecting the dilutive preferred and the effects noted above for the convertible bonds.

$$\frac{\text{Net profit for the year} + \text{Interest expense (net of tax)}}{\text{Weighted-average of ordinary shares outstanding} + \frac{\text{Shares issued upon conversion of preferred shares and conversion of bonds}}{12,000}} = \frac{€50,000 + 8,400}{12,000} = €2.92$$

The convertible debt is also dilutive, as it reduces EPS from €4.17 to €2.92. Together the convertible bonds and preferred reduced EPS from €4.60 to €2.92.

The complete computation of basic and diluted EPS under IAS 33 is shown in the following table:

<i>Items</i>	<i>EPS on outstanding ordinary shares (the "benchmark" EPS)</i>		<i>Basic</i>		<i>Diluted</i>	
	<u>Numerator</u>	<u>Denominator</u>	<u>Numerator</u>	<u>Denominator</u>	<u>Numerator</u>	<u>Denominator</u>
Profit for the year	€50,000		€50,000		€50,000	
Preferred dividend	(4,000)					
Ordinary shs. outstanding		10,000 shs.		10,000 shs.		10,000 shs.
Conversion of preferred				2,000		2,000
Conversion of bonds					8,400	8,000
Totals	<u>€46,000</u>	÷ <u>10,000 shs.</u>	<u>€50,000</u>	÷ <u>12,000 shs</u>	<u>€58,400</u>	÷ <u>20,000 shs.</u>
EPS		<u>€4.60</u>		<u>€4.17</u>		<u>€2.92</u>

The preceding example was simplified to the extent that none of the convertible securities were, in fact, converted during the year. In most real situations, some or all of the securities may have been converted, and thus actual reported earnings (and basic EPS) would already have reflected the fact that preferred dividends were paid for only part of the year and/or that interest on convertible debt was accrued for only part of the year. These factors would need to be taken into consideration in developing a time-weighted numerator and denominator for the EPS equations.

### Contingent Issuances of Ordinary Shares

As for the computation of basic EPS, shares whose issuance is contingent on the occurrence of certain events are considered outstanding and included in the computation of basic EPS only if the stipulated conditions have been met (i.e., the event has occurred). If at the end of the reporting period the triggering event has not occurred, issuance of the contingently issuable shares is not to be assumed for the computation of basic EPS.

Issuances that are dependent on certain conditions being met can be illustrated as follows. Assume that a condition or requirement exists in a contract to increase earnings over a period of time to a certain stipulated level and that, upon attainment of this targeted level of earnings, the issuance of shares is to take place. This is regarded as a contingent issuance of shares for purposes of applying IAS 33. If the condition is met at the end of the reporting period, the effect is included in basic EPS, even if the actual issuance takes place after year end (e.g., upon delivery of the audited financial statements, per terms of the contingency agreement).

If the condition must be met and then maintained for a subsequent period, such as for a two-year period, then the effect of the contingent issuance is excluded from basic EPS, but is included in diluted EPS. In other words, the contingent shares, which will not be issued until the defined condition is met for two consecutive years, are assumed to be met for diluted EPS computation if the condition is met at the end of the reporting period. Meeting the terms of the contingency for the current period forms the basis for the expectation that the terms may again be met in the subsequent period, which would trigger the issuance of the added shares, causing dilution of EPS.



In some instances the terms of the contingent issuance arrangement make reference to share prices over a period of time extending beyond the end of the reporting period. In such instances, if issuance is to be assumed for purposes of computing diluted EPS, only the prices or other data through the end of the reporting period should be deemed pertinent to the computation of diluted EPS. Basic EPS is not affected, of course, since the contingent condition is not met at the end of the reporting period.

IAS 33 identifies circumstances in which the issuance of contingent shares is dependent upon meeting both future earnings and future share price threshold levels. Reference must be made to both these conditions, as they exist at the end of the reporting period. If both threshold conditions are met, the effect of the contingently issuable shares is included in the computation of diluted EPS.

The standard also cites circumstances where the contingency does not pertain to market price of ordinary shares or to earnings of the reporting entity. One such example is the achievement of a defined business expansion goal, such as the opening of a targeted number of retail outlets; other examples could be the achievement of defined level of gross revenues, or development of a certain number of commercial contracts. For purposes of computing diluted EPS, the number of retail outlets, level of revenue, etc., at the end of the reporting period are to be presumed to remain constant until the expiration of the contingency period.

#### Example

Contingent shares will be issued at year-end 20XX, with 1,000 shares issued for each retail outlet in excess of the number of outlets at the base date, year-end 20XX-1. At year-end 20XX, seven new outlets are open. Diluted EPS should include the assumed issuance of 7,000 additional shares. Basic EPS would not include this, since the contingency period has not ended and no new shares are yet required to be issued.

#### Contracts Which May Be Settled in Shares or for Cash

Increasingly complex financial instruments have been issued by entities in recent decades. Among these are obligations that can be settled in cash or by the issuance of shares, at the option of the debtor (the reporting entity). Thus, debt may be incurred and later settled, at the entity's option, by increasing the number of its ordinary shares outstanding, thereby diluting EPS but averting the need to disperse its resources for purposes of debt retirement.

Note that this situation differs from convertible debt, discussed above, as it is the debtor, not the debt holder, which has the right to trigger the issuance of shares.

It is to be presumed that the debtor will elect to issue shares to retire this debt, if making that assumption results in a dilution of EPS. This is assumed for the calculation of diluted EPS, but is not included in basic EPS.

A similar result obtains when the reporting entity has written (i.e., issued) a call option to creditors, giving them the right to demand shares instead of cash in settlement of an obligation. Again, if dilutive, share issuance is to be presumed for diluted EPS computation purposes.

#### *Written put options*

The entity may also write put options giving shareholders the right to demand that the entity repurchase certain outstanding shares. Exercise is to be presumed if the effect is dilutive. According to IAS 33, the effect of this assumed exercise is to be calculated by assuming that the entity will issue enough new shares, at average market price, to raise the proceeds needed to honour the put option terms.

**Example**

If the entity is potentially required to buy back 25,000 of its currently outstanding shares at €40 each, it must assume that it will raise the required €1,000,000 cash by selling new ordinary shares into the market. If the average market price was €35 during the reporting period, it must be assumed that  $€1,000,000 \div €35 = 28,572$  shares would be issued, for a net dilution of about 3,572 net ordinary shares, which is used to compute diluted EPS.

The foregoing guidance does not apply, however, to the situation where the reporting entity holds options, such as call options on its own shares, since it is presumed that the options would only be exercised under conditions where the impact would be antidilutive. That is, the entity only would choose to repurchase its optioned shares if the option price were below market price. Similarly, if the entity held a put contract (giving it the right to sell shares to the option writer) on its own shares, it would only exercise this option if the option price were above market price. In either instance, the effect of assumed exercise would likely be antidilutive.

**Sequencing of Dilution Effects**

The sequence followed in testing the dilution effects of each of several series of convertible securities may affect the outcome, although this is not always true. It is best to perform the sequential procedures by computing the impact of each issue of potential ordinary shares from the most dilutive to the least dilutive. This rule also applies if convertible securities (for which the if-converted method will be applied) and options (for which the treasury stock approach will be applied) are outstanding simultaneously.

To determine the sequencing of the dilution analysis, it is necessary to use a “trial and error” approach. However, options and warrants should be dealt with first, since these will not affect the numerator of the EPS equation, and thus are most dilutive in their impact. Convertible securities are dealt with subsequently, and these issues will affect both numerator and denominator, with varying dilutive effects.

**No antidilution.** No assumptions of conversion should be made if the effect would be antidilutive. As in the discussion above, it may be that the sequence in which the different issues or series of convertible or other instruments that are potentially ordinary shares are considered will affect the ultimate computation. The goal in computing diluted EPS is to calculate the maximum dilutive effect. The individual issues of convertible securities, options, and other items should be dealt with from the most dilutive to the least dilutive to effect this result.

**Presentation and Disclosure Requirements under IAS 33**

Entities should disclose amounts used as the numerator in calculating basic EPS and diluted EPS along with a reconciliation of those amounts to profit or loss for the period. Disclosure is also required of the weighted-average number of ordinary shares used as the denominator in calculating basic EPS and diluted EPS along with a reconciliation of these denominators to each other, including instruments (i.e., contingently issuable shares) that could potentially dilute basic EPS in the future, but were not included in the calculation of diluted EPS because they were antidilutive for the period(s) presented.

If an entity chooses to disclose per share amounts using a reported component of the separate statement of profit or loss other than profit or loss for the period attributable to

ordinary equity holders, such amounts should be calculated using the weighted-average number of ordinary shares determined in accordance with the requirements of IAS 33; this will ensure comparability of the per share amounts disclosed.

In cases where an entity chooses to disclose the above per share amounts using a reported component of the separate statement of profit or loss, other than profit or loss for the year, a reconciliation is mandated by the standard, which should reconcile the difference between the reported component of profit or loss and profit or loss reported in the statement of profit or loss and comprehensive income or separate statement of profit or loss presented.

When additional disclosure is made by an entity of the above per share amounts, basic and diluted per share amounts should be disclosed with equal prominence (just as basic EPS and diluted EPS figures are given equal prominence).

Entities are encouraged to disclose the terms and conditions of financial instruments or contracts generating potential ordinary shares since such terms and conditions may determine whether or not any potential ordinary shares are dilutive and, if so, the effect on the weighted-average number of shares outstanding and any consequent adjustments to profit or loss attributable to the ordinary equity holders.

If changes (resulting from a bonus issue or share split, etc.) in the number of ordinary or potential ordinary shares occur after the end of the reporting period but before issuance of the financial statements, and the per share calculations reflect such changes in the number of shares, such a fact should be disclosed.

Entities are also encouraged to disclose a description of ordinary share transactions or potential ordinary share transactions other than capitalization issues and share splits, occurring after the end of the reporting period that are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES

Exemplum Reporting PLC			
Financial statements			
For the year ended 31 December 20XX			
<b>Earnings per share</b>			
From continuing operations			
Basic (cents per share)	13	X	X
Diluted (cents per share)	13	X	X
From continuing and discontinued operations			
Basic (cents per share)	13	X	X
Diluted (cents per share)	13	X	X
<b>13. Earnings per share</b>			
	<b>20XX</b>	20XX-1	
Reconciliation of net profit to basic earnings:			
Net profit attributable to equity holders of the parent	<u>X</u>	<u>X</u>	IAS33
Basic earnings	<u>X</u>	<u>X</u>	

Loss for the period on discontinued operations	X	X	
Basic earnings from continued operations	X	X	
Reconciliation of basic earnings to diluted earnings:			IAS33 p70
Basic earnings	X	X	
Interest on convertible debentures	X	X	
Diluted earnings	X	X	
Loss for the period on discontinued operations	X	X	
Diluted earnings from continued operations	X	X	
Reconciliation of basic weighted average number of ordinary IAS33 shares to diluted weighted average number of ordinary shares:	Number	Number	IAS33 p70
Basic weighted average number of ordinary shares	X	X	
Dilutive effect of convertible debentures	X	X	
Diluted weighted average number of ordinary shares	X	X	

Share options granted to employees could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share as they are anti-dilutive for the period presented.

The weighted number of shares used in the calculation of basic and diluted earnings per share is the same for continuing and total earnings per share calculations.

### Commentary on notes

#### Earnings per share

Where there has been any transaction in ordinary or potential ordinary shares after the statement of financial position date that has significantly changed the number of ordinary or potential ordinary shares in issue, a description of such transactions shall be given. IAS33 p70(d)

Capitalization, bonus or share split issues are required to be adjusted retrospectively and therefore the descriptive disclosure mentioned above would not apply to these types of issues. The fact that the per share calculations have been adjusted should be disclosed. IAS33 p64

## US GAAP COMPARISON

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The accounting and presentation under US GAAP for EPS is very similar to IFRS. Entities with simple capital structures, which are entities that have only one class of shares and no other potential equity instruments outstanding, present only basic EPS. Basic EPS is calculated by dividing the earnings available to ordinary shareholders by the average shares outstanding for the period (each quarter). This is done for operating results, net income and

discontinued operations. (In January 2015, US GAAP was revised to remove the concept of extraordinary items. This new accounting guidance is effective for year's beginning after December 15, 2015, with early adoption permitted. This amendment has aligned US GAAP with IFRS in this regard.) The earnings available to ordinary shareholders for an entity with a simple capital structure can differ if the entity has non-controlling interests.

Entities that have *potentially* issued shares must also present diluted earnings per share. The diluted EPS calculation includes the shares that would have been issued if events necessary to issue those shares had occurred (market price trigger). Potential shares include contingent share agreements, convertible debt, convertible preferred stock, options and warrants. For all potentially issued shares, it is assumed in the calculation that the shares were outstanding from either the beginning of the period or the date at which the instruments or agreements were issued.

The number of potentially issued shares that require the holder to convey to the issuer assets in exchange (i.e., options with a strike price) are adjusted for the assumption that the issuer will use those proceeds to purchase outstanding shares (referred to as the *Treasury Stock Method*). This has the effect of always reducing the number of shares in the calculation. The theoretical number of shares purchased is calculated by dividing the total theoretical proceeds by the average price per share of the securities in the period. Potentially issued shares that require the holder to convey assets to the issuer are only included in the calculation of diluted EPS if the average price per share is above the strike price. This is because it is assumed that a holder would not exercise the option or warrant if it is "out-of-the-money."

Potentially issued shares are only included in diluted EPS if the effect is to reduce EPS (or decrease loss per share) below basic EPS. These shares are called *antidilutive*. To maximize the dilution, each series or set of potential shares are added to outstanding shares in order of most dilutive to least dilutive. Shares that would be issued that do not require the conveyance of assets from the instrument holder to the issuer would be the most dilutive.

Dividends on preference shares are deducted from earnings to calculate earnings available to ordinary shares.

If an entity has participating shares outstanding, that is separate classes of shares that are entitled to different dividends, both the basic and diluted EPS must reflect this. This is referred to in US GAAP as a *two-tiered* calculation.

Mandatorily convertible instruments are not specifically addressed: however, an entity should consider whether or not the contract is considered participating and, if so, apply the two-class method.

The number of dilutive potential ordinary shares included in the year-to-date-period is a weighted-average of the dilutive potential ordinary shares included in each interim computation.

For contracts that are permitted to be settled in either common stock or cash at the entity's option, the presumption that the contract will be settled in ordinary shares if the effect is dilutive can be overcome if entity has an existing practice or stated policy that provides a reasonable basis to conclude that the contract will be settled partially or wholly in cash.

Instruments that contain embedded conversion features that are contingently convertible or exercisable on the basis of a market price trigger are included in diluted EPS (if dilutive) regardless of whether the market price trigger has been met.

The presentation of cash flow per share, or similar information, in the financial statements is specifically prohibited.

- b. That files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market.

If an entity that is not required to apply this IFRS chooses to disclose information about segments that does not comply with this IFRS, it shall not describe the information as segment information. This means that where an entity voluntarily chooses to disclose segment information, it can only state that it is compliant with IFRS 8 if all disclosure requirements have been met.

If a financial report contains both the consolidated financial statements of a parent that is within the scope of this IFRS as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

A regulatory requirement to file financial statements does not equate to financial statements linked to the process of issuing instruments to a public market. In such instances, the entity would not be subjected to the disclosure requirements of IFRS 8.

## DEFINITIONS OF TERMS

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**Chief operating decision maker.** The term "chief operating decision maker" identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others. Deciding who the chief operating decision maker is can be difficult and judgement is needed to ensure that the right person or persons have been identified. Where the board of directors include non-executive directors, it may not be appropriate to classify the board as the chief operating decision maker. This is due to the fact that the non-executive directors are not usually involved in resource allocation decisions; their role is a governance one and not a management one.

**Common costs.** Operating expenses incurred by the enterprise for the benefit of more than one business segment.

**Corporate assets.** Assets maintained for general corporate purposes and not used in the operations of any business segment.

**General corporate expenses.** Expenses incurred for the benefit of the corporation as a whole, which cannot be reasonably allocated to any segment.

**Identifiable assets.** Those tangible and intangible assets used by a business segment, including those the segment uses exclusively, and an allocated portion of assets used jointly by more than one segment.

**Intersegment sales.** Transfers of products or services, similar to those sold to unaffiliated customers, between business segments or geographic areas of the entity.

**Intrasegment sales.** Transfers within a business segment or geographic area.

**Operating activities.** The principal revenue producing activities of an entity and other activities that are not investing or financing activities.

**Operating profit or loss.** A business segment's revenue minus all operating expenses, including an allocated portion of common costs.

**Operating segment.** A component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

- Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segments and assess its performance; and
- For which discrete financial information is available.

**Reportable segment.** Operating segments that:

- Have been identified in accordance with the above definition or result from aggregating two or more of those segments in accordance with aggregation criteria; and
- Exceed the quantitative thresholds.

**Segment accounting policies.** The policies adopted for reporting the consolidated financial statements of the entity, as well as for segment reporting.

**Segment assets.** Operating assets employed by a segment in operating activities, whether directly attributable or reasonably allocable to the segment; these should exclude those generating revenues or expenses which are excluded from the definitions of segment revenue and segment expense.

**Segment expense.** Expense that is directly attributable to a segment, or the relevant portion of expense that can be allocated on a reasonable basis to a segment; it excludes interest expense, losses on sales of investments or extinguishment of debt, equity method losses of associates and joint ventures, income taxes and corporate expenses not identified with specific segments.

**Segment revenue.** Revenue that is directly attributable to a segment, or the relevant portion of revenue that can be allocated on a reasonable basis to a segment, and that is derived from transactions with parties outside the enterprise and from other segments of the same entity; it excludes interest and dividend income, and gains on sales of investments or extinguishment of debt.

**Transfer pricing.** The pricing of products or services between business segments or geographic areas.

## IDENTIFICATION

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Identification of operating segments within business organizations has grown in complexity over the years, and the conglomerate form of organization (where unrelated or dissimilar operations are united within one reporting entity, sometimes to provide the overall entity with benefits of countercyclicality among the constituent operations) has become normal practice, and it consequently has become necessary to concede that financial statements which present the full scope of an entity's operations on an aggregated basis declined markedly in usefulness without further relevant detail. While it is certainly possible to assess the overall financial health of the reporting entity using such financial reports, it is much more difficult to evaluate management's operating and financial strategies, particularly with regard to its emphases on specific lines of business or geographic spheres of operation. For example, the extent to which operating results for a given period are the consequence of the development of new products having greater potential for future growth, compared to more mature product lines which nonetheless still account for a majority of the entity's total sales, would tend to be masked in financial statements which did not present results by business segment.

IFRS 8 does not define, but requires an explanation of how segment profit or loss, segment assets and segment liabilities are determined and measured for each reportable segment. This standard also requires general and entity-wide disclosures, including

information about products and services, geographical areas, major customers and important factors used to identify an entity's reportable segments.

Therefore the core principle of IFRS 8 is the disclosure of information to enable users of an entity's financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates. This should be considered when an entity forms its judgments about how and what information should be disclosed.

## CONCEPTS AND REQUIREMENTS UNDER IFRS 8

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IFRS 8 establishes how an entity is to report information about its operating segments in *annual* financial statements. Additionally, due to a consequential amendment made to IAS 34, entities are required to report selected information about their operating segments in *interim* financial reports, when interim reports are issued. IFRS 8 also sets out requirements for related disclosures about products and services, geographical areas and major customers.

IFRS 8 requires that an entity report financial and descriptive information about its *reportable segments*. Reportable segments are defined as *operating segments* or aggregations thereof that meet certain defined criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, segment financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments. This conforms to the objective of putting users in the "shoes of management" in their ability to evaluate management performance.

In the past, there had been debate over the value and validity of disclosing results of operations on a segmental basis. IFRS 8 requires an entity to report a measure of operating segment profit or loss and of segment assets. It also requires the reporting entity to report a measure of segment liabilities and particular income and expense items if such measures are regularly provided to the chief operating decision maker. It requires reconciliations of total reportable segment revenues, total profit or loss, total assets, liabilities and other amounts disclosed for reportable segments to corresponding amounts in the entity's financial statements.

IFRS 8 also generally requires certain informational disclosures apart from any correspondence to information used in making management operating decisions. This includes information about the revenues derived from its products or services (or groups of similar products and services), about the countries in which it earns revenues and holds assets, and about major customers. However, information that is not prepared for internal use need not be reported if the necessary information is not available and the cost to develop it would be excessive.

Descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and those used in the entity's financial statements, and changes in the measurement of segment amounts from period to period must also be provided in the notes to the financial statements. This information is necessary for users to meaningfully interpret the operating segment financial data, including making comparisons to prior periods.



**Key Principles of IFRS 8**

1. IFRS 8 imposes a “management approach” to the identification of operating segments, which is to be based on internal reports that are regularly reviewed by the entity’s chief operating decision maker in order to allocate resources to the segment and assess its performance. Once an entity has done that it is required to determine its reportable segments. For purposes of this standard, an operating segment is a component of an entity:
  - a. That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
  - b. Whose operating results are regularly reviewed by the entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
  - c. For which discrete financial information is available. The “chief operating decision maker” designation does not necessarily refer to a single individual, but to a function within the reporting entity.
2. IFRS 8 allows for the discrete reporting of a component of an entity that sells primarily or exclusively to other operating segments of the entity, if the entity is managed that way under the predecessor standard.
3. The standard requires that the amount of each operating segment item (revenue, assets, etc.) that is reported be the same measure that is reported to the chief operating decision maker for the purposes of allocating resources to the segment and assessing its performance. This requirement can prove to be controversial, since it may well be the case, for many reporting entities, that internal measures will diverge from IFRS-compliant ones. (Note that IFRS do not control or even instruct on management reporting practices, but only govern external reporting.)
4. IFRS 8 requires reconciliations of total reportable segment revenues, total profit or loss, total assets and other total amounts disclosed for reportable segments to corresponding amounts in the entity’s financial statements.
5. The standard requires an explanation of how segment profit or loss and segment assets are measured for each reportable segment. This is necessitated by the fact that the proposed standard does not define these terms in the abstract.
6. It also requires that the entity report information about the revenues derived from its products or services (or groups of similar products and services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether that information is used by management in making operating decisions.
7. IFRS 8 requires the reporting entity to provide descriptive information about the way that the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and those used in the entity’s financial statements, and changes in the measurement of segment amounts from period to period.
8. Finally, it requires the reporting entity to report interest revenue separately from interest expense for each reportable segment, unless (principally for financial institutions) a majority of the segment’s revenues are from interest and the chief operating

decision maker relies primarily on net interest revenue to assess the performance of the segment and to make decisions about resources to be allocated to the segment.

IFRS 8 also expands disclosures of both segment and entity-wide information, which must include the following:

1. General information, which includes the factors used to identify the entity's operating segments, including the basis of organization, the judgements made by management in applying the aggregation criteria and the types of products and services from which each reportable segment derives its revenues.
2. Information about profit, including a measure (unspecified) of profit or loss and total assets and liabilities for each reportable segment; a number of specified income statement headings for each reportable segment—if the amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker (or are otherwise regularly provided to the chief operating decision maker); and, for each reportable segment (if the amounts are included in the determination of segment assets, or otherwise are also reviewed by the chief operating decision maker), the amount of investment in associates and joint ventures accounted for by the equity method; and the total expenditures for additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts. The standard refers to non-current assets but the IASB annotated this statement to clarify that for assets classified according to a liquidity presentation, the term non-current assets refers to assets that are expected to be recovered more than 12 months after the reporting period. Also to be disclosed would be all measurements of segment profit or loss and segment assets to be explained, including an explanation of the nature of any differences between amounts reported for segment purposes and those for the entity as a whole; the nature and effect of any changes from prior periods in the measurements used; and the nature and effect of any asymmetrical allocations to reportable segments.
3. Reconciliations—These are required in respect of the total of the reportable segments' revenues to the entity's revenue, with all material reconciling items separately identified and described; of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before income tax expense or income and discounted operations; of the total of the reportable segments' assets to the (continued) entity's assets; of the total of the reportable segments' liabilities to the (continued) entity's liabilities and of the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.
4. Entity-wide disclosures for all entities (including those having only a single reportable business segment), of information about its products and services, geographical areas and major customers. This requirement applies, regardless of the entity's organization, if the information is not included as part of the disclosures about segments.

IFRS 8 requires the expanded application of segment reporting requirements to interim financial statements. While previously this was seen as an onerous burden, the embrace of the "management approach," and the countenancing (at least implicitly) of non-IFRS measures in segment data, means that the burden would be lightened, making inclusion in interim reports more feasible. Of course, there is no absolute requirement under IFRS to publish interim

reports, nor is there a requirement to have interim financial statements comply with IFRS. However, if such IFRS-compliant interim financial reports are prepared, they will now have to include certain operating segment information (for qualifying reporting entities).

### **Operating Segments and Reportable Segments**

IFRS 8 defines reportable segments as being a subset of operating segments. In other words, there may be certain operating segments that fail to meet the threshold test for being reportable under this standard. Therefore, an understanding of these key concepts is vital to the proper application of the standard.

#### ***Operating segments***

An operating segment is a component of an entity:

1. That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
2. Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
3. For which discrete financial information is available.

Revenue generation is not an absolute threshold test for an operating segment. An operating segment may engage in business activities for which it has yet to earn revenues; for example, start-up operations may be operating segments before earning revenues.

By the same token, not every part of an entity is necessarily an operating segment or part of an operating segment. Thus, a corporate headquarters, as well as certain functional departments, may earn no revenues, or may generate revenues that are merely incidental to the activities of the entity as a whole. These would not be deemed to be operating segments under the definitions set forth under IFRS 8. For the purposes of IFRS 8, an entity's post-employment benefit plans are not operating segments, either.

Start-up operations may be operating segments, even where the entity is not yet earning any revenues from its operations. Similarly, not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. The standard notes specifically that an entity's post-employment benefit plans are not operating segments.

In situations where all of the segment's revenues and expenses are derived from intra-group transactions, these segments may still qualify as operating segments. Such a situation may occur in a vertically integrated operation. Vertically integrated operations are structures that combine many or all of the production and selling processes within one entity.

For many entities, the three characteristics of operating segments set forth above will serve to clearly identify its operating segments. In other situations, an entity may produce reports in which its business activities are presented in a variety of ways (particularly in so-called "matrix organization" structures, where there are multiple and overlapping lines of reporting responsibilities). If the chief operating decision maker uses more than one set of segment information, other factors may be necessary to identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of

directors. Of course, any such decision should be documented, and should be maintained over time, to the extent possible, in order to ensure comparability of disclosures. The chief operating decision maker should review segment definitions to ensure accuracy and consistency.

A discontinued operation can meet the definition of an operating segment, if it continues to engage in business activities, the operating results are regularly reviewed by the CODM and there is discrete financial information available to facilitate the review.

### **Reportable segments**

Only reportable segments give rise to the financial statement disclosures set forth by IFRS 8. Reportable segments are operating segments as defined above, or *aggregations* of two or more such operating segments, that exceed the quantitative thresholds described below.

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may *optionally* be aggregated into a single operating segment if aggregation is consistent with the core principle of IFRS 8, the segments have similar economic characteristics, and segments are similar in each of the following respects:

1. The nature of the products and services;
2. The nature of the production processes;
3. The type or class of customer for their products and services;
4. The methods used to distribute their products or provide their services; and
5. If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

It should be noted that the aggregation criteria are tests and not indicators and that all criteria must be satisfied before operating segments may be aggregated.

The process for determining reportable segments is not straightforward; IFRS 8 has a useful flowchart that can assist in the determination of reportable segments. This flowchart is summarized below:

1. Identify operating segments;
2. Determine whether any operating segments meet all the aggregation criteria and if so, aggregate them;
3. Review the identified operating segments and aggregated groups of operating segments to see if they individually meet the quantitative thresholds. Those that do are treated as reportable segments;
4. For the remainder, check whether any of the identified operating segments or aggregated groups of operating segments meet a majority of the aggregation criteria. If they do, aggregate them and treat as reportable segments if desired. Individual operating segments can also be treated as reportable segments even if they are not aggregated with another segment or do not meet the quantitative threshold;
5. Test whether the external revenues of reportable segments identified so far represent 75% or more of the entity's external revenue. If they do, then aggregate the remaining segments into a segment called "All other segments," which is not a reportable segment as defined by IFRS 8. If they do not, then additional reportable segments must be identified until the total of reportable segments reaches the 75% point.

Once it has been determined which operating segments may be aggregated, any one of the following quantitative thresholds must also be met when identifying reportable segments:

1. The segment's reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.
2. The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss, and (ii) the combined reported loss of all operating segments that reported a loss.
3. Its assets are 10% or more of the combined assets of all operating segments.

Furthermore, if the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments must be identified as reportable segments, even if they do not meet the criteria established under IFRS 8, until at least 75% of the entity's revenue is included in reportable segments.

A reporting entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria set forth above. Thus, a catch-all ("all other segments") category should not be used, unless truly immaterial. The sources of the revenue included in the all other segments category must be described.

More segments may be optionally defined by management as being reportable, even if the foregoing criteria are not met. Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

This may be particularly relevant if, for various reasons, an operating segment traditionally meeting the test as a reportable segment falls below each threshold in the current year, but management expects the segment to regain its former prominence within a relatively brief time. To ensure interperiod comparability, it may be maintained as a reportable segment notwithstanding its current diminished significance. If management judges that an operating segment identified as a reportable segment in the immediately preceding periods is of continuing significance, information about that segment must, per IFRS 8, continue to be reported separately in the current period even if it no longer meets the criteria for reportability.

It is important to note that the above is different from the aggregation of segments that may be done prior to the initial determination of reportable segments, where all of the criteria must be satisfied. The distinction between the two stages of aggregation is due to the following:

- a. In the first stage, the aggregation takes place before determining the reportable segments. Each of the aggregation criteria is considered to be significant; accordingly, all criteria must be satisfied;
- b. In the second stage, the reportable segments have already been identified and the segments that are being aggregated are those that do not meet the thresholds for treatment as reportable segments. Accordingly, the aggregation criteria is less important.

If an operating segment is identified as a reportable segment in the current period in accordance with the above-stated quantitative thresholds, segment data for a prior period presented for comparative purposes is to be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

The standard notes that there may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed (the so-called information overload situation). Although no precise limit has been determined, as the number of segments that are reportable increases above 10, the entity should consider whether a practical limit has been reached. However, there is no absolute requirement to limit the number of segments.

## DISCLOSURE REQUIREMENTS

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A reporting entity is required to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

The reporting entity is required to disclose the following *for each period for which a statement of comprehensive income is presented*:

1. General information:
  - a. The factors used to identify the entity's reportable segments, including the basis of organization (for example, whether management has chosen to organize the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors, and whether operating segments have been aggregated);
  - b. The judgements made by management in applying the aggregation criteria in paragraph 12 of IFRS 8. This includes a brief description of the operating segments that have been aggregated in this way and the economic indicators that have been assessed in determining that the aggregated operating segments share similar economic characteristics; and
  - c. The types of products and services from which each reportable segment derives its revenues.
2. Information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement, as follows:
  - a. A measure of profit or loss for each reportable segment;
  - b. A measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the chief operating decision maker;
  - c. The following information about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker even if not included in that measure of segment profit or loss:
    1. Revenues from external customers;
    2. Revenues from transactions with other operating segments of the same entity;



3. Interest revenue;
4. Interest expense;
5. Depreciation and amortization;
6. Material items of income and expense disclosed in accordance with IAS 1;
7. The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
8. Income tax expense or income; and
9. Material non-cash items other than depreciation and amortization.

An entity is to report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

- d. The reporting entity is to disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the measure of segment assets:
  1. The amount of investment in associates and joint ventures accounted for by the equity method; and
  2. The amounts of additions to non-current assets other than financial instruments, deferred tax assets, net defined benefit assets and rights arising under insurance contracts. If the entity does not present a classified statement of financial position, non-current assets are to be deemed those that include amounts expected to be recovered more than 12 months after the date of the statement of financial position.
- e. An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:
  1. The basis of accounting for any transactions between reportable segments;
  2. The nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before tax and discontinued operations (if not apparent from reconciliations as per point 3 below);
  3. The nature of any differences between the measurements of the reportable segments' assets and the entity's assets operations (if not apparent from reconciliations as per point 3 below);
  4. The nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities operations (if not apparent from reconciliations as per point 3 below);
  5. The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measurement of segment profit or loss; and
  6. The nature and effect of any asymmetrical allocations to reportable segments.

3. Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts as follows:
  - a. The total of the reportable segments' revenues to the entity's revenue.
  - b. The total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items.
  - c. The total of the reportable segments' assets to the entity's assets if the segment assets are reported in accordance with paragraph 23.
  - d. The total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported to the entity's chief operating decision maker.
  - e. The total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

IFRS 8 dictates that all material reconciling items are to be separately identified and described. For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies is required to be separately identified and described.

IFRS 8 also mandates that reconciliations of statements of financial position amounts for reportable segments to the entity's statement of financial position amounts be presented for *each date* at which a *statement of financial position* is presented. If, as is typical, comparative statements of financial position are presented, information for prior periods is to be presented.

If the reporting entity changes the structure of its internal organization in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, is to be restated, unless the information is not available and the cost to develop it would be excessive. The determination of whether the information is not available and the cost to develop it would be excessive must be made separately for each individual item of disclosure—thus a blanket conclusion regarding impracticability would normally not be appropriate. Following a change in the composition of its reportable segments, the entity discloses whether it has restated the corresponding items of segment information for earlier periods.

Furthermore, if the reporting entity has changed the structure of its internal organization in a manner that causes the composition of its reportable segments to change, and if segment information for earlier periods, including interim periods, is *not* restated to reflect the change, it must disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive. This requirement is expected to discourage frequent changes in structure affecting segment reporting.

#### ***Entity-wide disclosure requirements***

IFRS 8 also mandates disclosures of certain entity-wide data. These disclosures are required regardless of whether the entity has multiple reportable segment disclosures to be made under this standard. These disclosures need not be provided, if already part of the reportable segment disclosures.



1. *Information about products and services.* Revenues from external customers for each product and service, or each group of similar products and services, are to be identified, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed. The amounts of revenues reported are to be based on the financial information used to produce the entity's financial statements.
2. *Information about geographical areas.* Unless the necessary information is not available and the cost to develop it would be excessive, the following information is required:
  - a. Revenues from external customers (1) attributed to the entity's country of domicile, and (2) attributed to all foreign countries in total from which the entity derives revenues. If revenues from an individual foreign country are material, those revenues are to be disclosed separately. An entity is required to disclose the basis for attributing revenues from external customers to individual countries.
  - b. Non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (1) located in the entity's country of domicile, and (2) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately. Non-current assets are to be defined as assets that include amounts expected to be recovered more than 12 months after the reporting date.

The amounts reported are to be based on the financial information that is used to produce the entity's financial statements. If the necessary information is not available and the cost to develop it would be excessive, that fact shall be disclosed. An entity may provide, in addition to the information required by this paragraph, subtotals of geographical information about groups of countries.

3. *Information about major customers.* Information about the extent of the reporting entity's reliance on its major customers must be provided. If revenues from transactions with a single external customer amount to 10% or more of the entity's revenues, it is to disclose that fact, the total amount of revenues from each such customer, and the identity of segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or amount of revenues that each segment reports from that customer. Originally, IFRS 8 explained that for the purposes of this requirement, a group of entities known to be under common control is to be considered a single customer, and a government (national, state, provincial, territorial, local or foreign) and entities known to be under the control of that government are to be considered a single customer. IAS 24, *Related Parties*, was revised during November 2009, and a key change arising from this revision was that transactions between components of a government and entities under the control of that government are no longer necessarily disclosable related-party transactions solely by virtue of the fact that they relate to the same government. As a result of the revision to IAS 24, IFRS 8 was consequently amended to reflect this thinking, and IFRS 8 now requires the application of judgement to assess whether a government (including government agencies and similar bodies whether local, national or international) and entities known to the reporting entity to be under the control of that government are considered a single customer. In assessing this, the reporting entity should consider the extent of economic integration between those entities.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES UNDER IFRS

### Roche Group Annual report 2012

#### Notes to the Consolidated Financial Statements

#### 1. Summary of significant accounting policies

#### 6. Segment information

##### (a) Information on reportable segments

Management has determined the operating segments based on the reports regularly reviewed by the chief operating decision maker (“CODM”) in making strategic decisions. Each operating segment is managed separately by a dedicated Chief Executive Officer and management team allowing management to maintain and develop the specific identity of each Maison. These operating segments have been aggregated into four reportable segments as follows:

- Jewelry Maisons—businesses whose heritage is in the design, manufacture and distribution of jewelry products; these comprise Cartier and Van Cleef & Arpels;
- Specialist Watchmakers—businesses whose primary activity includes the design, manufacture and distribution of precision timepieces. The Group’s Specialist Watchmakers comprise Piaget, A. Lange & Sohne, Jaeger-LeCoultre, Vacheron Constantin, Officine Panerai, IWC, Baume & Mercier and Roger Dubuis;
- Montblanc Maison—a business whose primary activity includes the design, manufacture and distribution of writing instruments; and
- Other—other operations mainly comprise Alfred Dunhill, Lancel, Chloe, Net-a-Porter, Purdey, textile brands and other manufacturing entities.

The entire product range of a particular Maison, which may include jewelry, watches, writing instruments and leather goods, is reflected in the sales and operating result for that segment. The non-separable costs of operating multibrand regional platforms are allocated to individual operating segments using allocation keys most relevant to the nature of the expense being allocated. Unallocated corporate costs represent the costs of the Group’s corporate operations which are not attributed to the segments. Performance measurement is based on segment contribution before corporate costs, interest and tax, as management believes that such information is most relevant in evaluating the results of segments relative to other entities that operate within similar markets. Intersegment transactions between different fiscal entities are transacted at prices that reflect the risk and rewards transferred and are entered into under normal commercial terms and conditions. Intersegment transactions within the same fiscal entity are transacted at cost. All such transactions are eliminated in the reports reviewed by the CODM.

The segment results for the years ended March 31 are as follows:

	2012	2011
	<u>€m</u>	<u>€m</u>
<b>External sales</b>		
Jewelry Maisons	4,590	3,479
Specialist Watchmakers	2,323	1,774
Montblanc Maison	723	672
Other	1,231	967
	<b>8,867</b>	<b>6,892</b>

<b>Operating result</b>		
Jewelry Maisons	1,510	1,062
Specialist Watchmakers	539	379
Montblanc Maison	119	109
Other	(35)	(34)
<b>Operating profit from reportable segments</b>	<b>2,133</b>	<b>1,516</b>
Unallocated corporate costs	(93)	(161)
<b>Consolidated operating profit before finance and tax</b>	<b>2,040</b>	<b>1,355</b>
Finance costs	(314)	(292)
Finance income	79	111
Share of post-tax results of associated undertakings	(1)	101
<b>Profit before taxation</b>	<b>1,804</b>	<b>1,275</b>
Taxation	(264)	(196)
<b>Profit for the year</b>	<b>1,540</b>	<b>1,079</b>

An impairment charge of €2 million is included within the Other reportable segment for 2012 (2011: €1 million included within each of the Jewelry Maisons and the Other reportable segment). The segment assets which are reviewed by the CODM comprise inventories and trade debtors.

	<i>2012</i>	<i>2011</i>
	<u>€m</u>	<u>€m</u>
<b>Segment assets</b>		
Jewelry Maisons	2,149	1,590
Specialist Watchmakers	1,219	956
Montblanc Maison	357	307
Other	417	328
	<b>4,142</b>	<b>3,181</b>
Total assets for reportable segments	4,142	3,181
Property, plant and equipment	1,529	1,267
Goodwill	479	441
Other intangible assets	316	314
Investment property	64	–
Investments in associated undertakings	10	7
Deferred income tax assets	443	349
Financial assets at fair value through profit or loss	2,469	2,224
Other non-current assets	248	211
Other receivables	274	205
	<i>2012</i>	<i>2011</i>
	<u>€m</u>	<u>€m</u>
Derivative financial instruments	27	148
Prepayments	116	119
Cash at bank and on hand	1,636	1,227
<b>Total assets</b>	<b>11,753</b>	<b>9,693</b>

The CODM also reviews additions to property, plant, and equipment, and other intangible assets as follows:

	<i>2012</i>	<i>2011</i>
	<u>€m</u>	<u>€m</u>
<b>Additions to non-current assets:</b>		
<b>Property, plant, and equipment, and other intangible assets</b>		
Jewelry Maisons	185	125
Specialist Watchmakers	119	65
Montblanc Maison	31	24
Other	101	60
Unallocated	81	34
	<b>517</b>	<b>308</b>

**(b) Information about geographical areas**

Each reporting segment operates on a worldwide basis. External sales presented in the three main geographical areas where the Group's reportable segments operate are as follows:

	<i>2012</i>	<i>2011</i>
	<u>€m</u>	<u>€m</u>
<b>Europe</b>	<b>3,097</b>	<b>2,588</b>
France	669	551
Switzerland	347	303
Germany, Italy and Spain	670	606
Other Europe	1,411	1,128
<b>Asia</b>	<b>4,517</b>	<b>3,306</b>
China/Hong Kong	2,412	1,645
Japan	833	737
Other Asia	1,272	924
<b>Americas</b>	<b>1,253</b>	<b>998</b>
USA	973	758
Other Americas	280	240
	<b>8,867</b>	<b>6,892</b>

Sales are allocated based on the location of the wholesale customer, the boutique or the shipping address for online transactions. The total non-current assets other than financial instruments and deferred tax assets located in Switzerland, the Company's domicile, and the rest of the world are as follows:

	<i>2012</i>	<i>2011</i>
	<u>€m</u>	<u>€m</u>
Switzerland	1,217	1,056
Rest of the world	1,331	1,104
	<b>2,548</b>	<b>2,160</b>

Segment assets are allocated based on where the assets are located.

**(c) Information about products**

External sales by product are as follows:

	2012	2011
	<u>€m</u>	<u>€m</u>
Watches	4,404	3,320
Jewelry	2,248	1,685
Leather goods	721	602
Writing instruments	357	359
Clothing and other	1,137	926
	<b>8,867</b>	<b>6,892</b>

**(d) Major customers**

Sales to no single customer represented more than 10% of total revenue. Given the local nature of the luxury goods wholesale and retail businesses, there are no major customer relationships.

**Hays plc**  
**Financial Year 2012**

**4. Segmental Information****Adoption of IFRS 8, Operating Segments**

The Group has adopted IFRS 8, Operating Segments, with effect from 1 July 2009. IFRS 8 requires operating segments to be identified on the basis of internal reports about components of the Group that are regularly reviewed by the chief operating decision maker to allocate resources to segments and to assess their performance.

As a result the Group continues to segment the business into three regions, Asia Pacific, Continental Europe & Rest of World, and United Kingdom & Ireland.

The Group's continuing operations comprise one class of business, that of qualified, professional and skilled recruitment.

**Net fees and operating profit from continuing operations**

The Group's Management Board, which is regarded as the chief operating decision maker, uses net fees by segment as its measure of revenue in internal reports. This is because net fees exclude the remuneration of temporary workers, and payments to other recruitment agencies where the Group acts as principal, which are not considered relevant in allocating resources to segments. The Group's Management Board considers net fees for the purpose of making decisions about allocating resources. The reconciliation of turnover to net fees can be found in note 6.

(In £s million)	2012	2011
<b>Net fees from continuing operations</b>		
Asia Pacific	242.2	210.0
Continental Europe & Rest of World	266.5	220.4
United Kingdom & Ireland	225.3	241.7
	<b>734.0</b>	672.1

(In £s million)	2012	2011 Before exceptional items	2011 Exceptional items	2011
<b>Operating profit from continuing operations</b>				
Asia Pacific	<b>90.9</b>	78.1	–	78.1
Continental Europe & Rest of World	<b>43.7</b>	32.4	–	32.4
United Kingdom & Ireland	<b>(6.5)</b>	3.6	4.1	7.7
	<b>128.1</b>	114.1	4.1	118.2

The Group does not report items below operating profit by segment in its internal management reporting. The full detail of these items can be seen in the Group Consolidated Income Statement on page 67.

There is no material difference between the segmentation of the Group's turnover by geographic origin and destination.

#### Net trade receivables

For the purpose of monitoring performance and allocating resources from a balance sheet perspective, the Group's Management Board monitors trade receivables net of provisions for impairments only on a segment by segment basis. These are monitored on a constant currency basis for comparability through the year. These are shown below and reconciled to the totals as shown in note 18.

(In £s million)	As reported internally	Foreign exchange	2012	As reported internally	Foreign exchange	2011
Net trade receivables						
Asia Pacific	76.1	(1.7)	<b>74.4</b>	59.9	9.9	69.8
Continental Europe & Rest of World	157.3	(17.4)	<b>139.9</b>	104.7	10.6	115.3
United Kingdom & Ireland	137.7	(0.6)	<b>137.1</b>	160.0	0.5	160.5
	371.1	(19.7)	<b>351.4</b>	324.6	21.0	345.6

#### Major customers

Included in turnover is an amount of approximately £587 million (2011: £540 million) which arose from sales to the Group's largest customer, which were generated within the United Kingdom & Ireland. This is the only customer to exceed 10% of the Group's turnover, however as it includes a significant element of remuneration of temporary workers and remuneration of other recruitment agencies, it represents less than 2% of the Group's net fees.

## NEW DEVELOPMENTS

In July 2012, the IASB published a request for information as part of its post-implementation review of IFRS 8. The review sought feedback on whether the standard is functioning as intended, as well as practical information on the challenges and costs associated with implementing the standard.

The IASB has been discussing the feedback received and has published its report on the post-implementation review of IFRS 8. This concludes that the standard is generally functioning as anticipated. The post-implementation review identified a number of areas for potential improvement and amendment. The IASB will review further analysis of these areas and will consider whether some of these areas should be addressed in a narrow-scope amendment to IFRS 8 and whether others should be considered for a broader project as part of the IASB's Agenda Consultation in 2015.

## US GAAP COMPARISON

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The IASB and FASB converged their segment reporting guidance in 2009. Consequently, the standards are nearly identical, with the following exceptions:

- Similar to IFRS, US GAAP requires an entity to provide a measure of assets that the chief operating decision maker uses in evaluating the performance of the segments. This includes expenditures on long-lived assets (some are excluded). US GAAP excludes goodwill. IFRS does not.
- US GAAP does not require disclosure of a measure of segment liabilities. IAS 8 requires disclosure of segment liabilities if such a measure is regularly provided to the chief operating decision maker.
- A matrix organization employs multiple management reporting relationships for the functions of people. US GAAP requires that an entity with a matrix form of organization to determine operating segments based on products and services. IFRS requires such an entity to determine operating segments by reference to the core principle of the IFRS.
- US GAAP provides specific guidance for determining operating segments in certain circumstances (e.g., for equity method investees, certain corporate divisions and divisions that do not have assets allocated for internal reporting purposes).

that transactions with related parties may not be effected at the same amounts or terms as are those between unrelated parties. For that reason, extensive disclosure of such transactions is deemed necessary to convey a full picture of the entity's position and results of operations.

While IAS 24 has been operative for over two decades, it is commonly observed that related-party transactions are not being properly disclosed in all instances. This is due in part, perhaps, to the perceived sensitive nature of such disclosures and fear of giving out too much information that may be detrimental to the reporting entity. As a consequence, even when a note to financial statements that is captioned "related-party transactions" is presented, it is often fairly evident that the spectrum of disclosures required by IAS 24 has not been included. There seems to be particular resistance to reporting certain types of related-party transactions, such as loans to directors, key management personnel or close members of the executives' families.

IAS 1 demands, as a prerequisite to asserting that financial statements have been prepared in conformity with IFRS, that there is *full compliance* with all IFRS. This requirement pertains to all recognition and measurement standards, and extends to the disclosures to be made as well. As a practical matter, it becomes incumbent upon the management and directors as those responsible for preparation of financial statements to ascertain whether disclosures, including related-party disclosures, comply with IFRS when the financial statements represent such to be the case.

#### Sources of IFRS

IAS 24, 28, IFRS 10, 11

## DEFINITIONS OF TERMS

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**Close members of the family of an individual.** For the purpose of IAS 24, close members of the family of an individual are defined as "those family members that may be expected to influence, or be influenced by, that person in their dealings with the entity." The following may be considered close members of the family: an individual's domestic partner, spouse and children, children of the individual's spouse or domestic partner, and dependents of the individual or the individual's spouse or domestic partner.

**Compensation.** Compensation encompasses all employee benefits (as defined in IAS 19) and also includes share-based payments as envisaged in IFRS 2. Employee benefits include all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect to activities of the entity. Compensation thus includes short-term employee benefits (such as wages, salaries, paid annual leave), post-employment benefits (such as pensions), other long-term benefits (such as long-term disability benefits), termination benefits and share-based payments.

**Control.** An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

**Government.** Government, government agencies and similar bodies whether local, national or international.

**Government-related entity.** An entity that is controlled, jointly controlled or significantly influenced by a government.

**Interest in another entity.** This is a contractual or non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity. An



interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical customer–supplier relationship.

**Joint control.** This refers to the contractually agreed sharing of control over an economic activity. This only exists when the strategic financial and operating decisions relating to the activity require the unanimous consent of the venturers.

**Key management personnel.** IAS 24 defines key management personnel as “those persons having authority and responsibility for planning, directing, and controlling the activities of the reporting entity, including directors (whether executive or otherwise) of the entity.” Key management personnel would include the Board and departmental heads.

**Related parties.** For the purpose of IAS 24, a related party is a person or entity that is related to the entity that is preparing its financial statements (referred to as the ‘reporting entity’).

- a. A person or a close member of that person’s family is related to a reporting entity if that person:
  - i. Has control or joint control over the reporting entity;
  - ii. Has significant influence over the reporting entity; or
  - iii. Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- b. An entity is related to a reporting entity if any of the following conditions applies:
  - i. The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  - ii. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  - iii. Both entities are joint ventures of the same third party.
  - iv. One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  - v. The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  - vi. The entity is controlled or jointly controlled by a person identified in (a).
  - vii. A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
  - viii. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

**Related-party transactions.** Related-party transactions are defined as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

**Significant influence.** The power to participate in the financial and operating policy decisions of that other entity, but not control them.

**Structured entity.** An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

## IDENTIFICATION

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### The Need for Related-Party Disclosures

For strategic or other reasons, entities will sometimes carry out certain aspects of their business activities through associates or subsidiaries. For example, in order to ensure that it has a guaranteed supply of raw materials, an entity may decide to purchase a portion of its requirements (of raw materials) through a subsidiary or, alternatively, will make a direct investment in its vendor, to assure continuity of supply. In this way, the entity might be able to control or exercise significant influence over the financial and operating decisions of its major supplier (the investee), including ensuring a source of supply and, perhaps, affecting the prices charged. Such related-party relationships and transactions are thus a normal feature of commerce and business, and need not suggest any untoward behaviour.

A related-party relationship could have an impact on the financial position and operating results of the reporting entity because:

1. Related parties may enter into certain transactions with each other which unrelated parties may not normally want to enter into (e.g., uneconomic transactions and transactions done at negotiated terms).
2. Amounts charged for transactions between related parties may not be comparable to amounts charged for similar transactions between unrelated parties (either higher or lower prices than arm's-length).
3. The mere existence of the relationship may sometimes be sufficient to affect the dealings of the reporting entity with other (unrelated) parties. (For instance, an entity may cease purchasing from its former major supplier upon acquiring a subsidiary which is the other supplier's competitor.)
4. Transactions between entities would not have taken place if the related-party relationship had not existed. For example, a company sells its entire output to an associate at cost. The producing entity might not have survived but for these related-party sales to the associate, if it did not have enough business with arm's-length customers for the kind of goods it manufactures.
5. The existence of related-party relationships may result in certain transactions *not* taking place, which otherwise would have occurred. Thus, even in the absence of actual transactions with related entities, the mere fact that these relationships exist could constitute material information from the viewpoints of various users of financial statements, including current and potential vendors, customers and employees. Related-party information is thus unique, in that even an absence of transactions might be deemed a material disclosure matter.
6. Certain related party transactions may have tax implications, especially if transactions are carried out at negotiated terms across borders.

Because of issues such as those mentioned above, which often distinguish related-party transactions from those with unrelated entities, accounting standards (including IFRS) have almost universally mandated financial statement disclosure of such transactions. Disclosures of related-party transactions in financial statements is a means of conveying to users of financial statements the messages that certain related-party relationships exist as of the date of the financial statements, and that certain transactions were consummated with related parties during the period which the financial statements cover, together with the financial impacts of these related-party transactions have been incorporated in the financial statements being presented. Since related-party transactions could have an effect on the financial position and operating results of the reporting entity, disclosure of such transactions would be prudent based on the increasingly cited principle of transparency (in financial reporting). Only if such information is disclosed to the users of financial statements will they be able to make informed decisions.

### **Scope of the Standard**

IAS 24 is to be applied in dealing with related parties and transactions between a reporting entity and its related parties. The requirements of this standard apply to the financial statements of each reporting entity. IAS 24 sets forth disclosure requirements only; it does not prescribe the accounting for related-party transactions, nor does it address the measurements to be applied in the instance of such transactions. Thus, related-party transactions are reported at the nominal values ascribed to them, and are not subject to further interpretation for financial reporting purposes, since there is generally no basis upon which to conclude, or even speculate, about the extent to which related-party transactions might approximate or vary from those between unrelated parties with regard to prices or other terms of sale. IAS 24 does however prescribe that transactions with related parties will only be described as having taken place at an arm's length if that is factually correct.

IAS 24 is to be employed in determining the existence of related-party transactions; identifying the outstanding balances between related parties; concluding on whether disclosures are required under the circumstances; and determining the content of such disclosures.

Related-party disclosures are required not only in the consolidated (group) financial statements, but also in the separate financial statements of the parent entity or a venturer or investor. In separate statements any intragroup transactions and balances must be disclosed in the related-party note, although these will be eliminated in consolidated financial reports. When intragroup transactions and balances are eliminated on consolidation such transactions and balances are not required to be disclosed under IAS 24. However, transactions and balances between an investment entity and its subsidiaries that are accounted for at fair value through profit or loss (and therefore not consolidated) need to be disclosed.

IAS 24 does not address the issue of timing on when two parties become or cease to become related and whether disclosures are required of transactions with a party that was related for only part of the reporting period. The recommended practice is that where a transaction took place while the party was related, it should be disclosed. In respect of balances with related parties, these should be disclosed either if the transaction took place when the parties were related, or if the parties were related at the reporting date. In respect of parent and ultimate parent disclosures, where there was a change during the reporting period, this change should be disclosed including previous and new parent and ultimate controlling parties.

## Applicability

The requirements of the standard should be applied to related parties as identified in the definition of a related party.

## Substance over Form

The standard clarifies that in applying the provisions of IAS 24 to each possible related-party relationship, consideration should be given to the substance of the relationship and not merely to its legal form. Thus, certain relationships might not rise to the level of related parties for the purpose of necessitating disclosure under the provisions of IAS 24. Examples of such situations follow:

1. Two entities having only a common director or other key management personnel, notwithstanding the specific requirements of IAS 24 above.
2. Agencies and entities such as:
  - a. Providers of finance (e.g., banks and creditors);
  - b. Trade unions;
  - c. Public utilities;
  - d. Government departments and agencies.
3. Entities upon which the reporting entity may be economically dependent, due to the volume of business the entity transacts with them. For example:
  - a. A single customer;
  - b. A major supplier;
  - c. A franchisor;
  - d. A distributor; or
  - e. A general agent.
4. Two venturers, simply because they share joint control over a joint venture.

### Example

#### The following scenarios apply in the business model of Entity A

The Entity is a manufacturer of electronic products. All of its supplies are sourced from one vendor for guaranteed supplies of the right quality and within time since the company operates a Just In Time (JIT) model. The finished products are sold to entities it (Entity A) can either control or exercise significant influence over. The entity also transacts with members of its top management and their relatives. The transactions are as follows;

- a. Entity A purchases all its raw materials and parts from Entity B. Due to the high quality of the material that Entity B has provided over the last 15 years, Entity A has never purchased from any other supplier. Thus it may be considered economically dependent on Entity B.
- b. Entity A sells 65% of its output to a company owned by one of the directors (Entity c), 25% to a company that is its “associate” by virtue of owning 25% of the share capital (Entity D) and the balance through a company owned by the Entity A’s sole financiers (Entity E).
- c. Entity A stores the raw material and the finished goods in a warehouse that is leased from another company (Entity F) where the managing director is a non-executive director.
- d. Entity A has provided an interest-free loan to a company owned by its managing director (Entity G) for the purposes of financing the purchase of delivery vans which the company

owned by the managing director is using for transporting goods from the warehouse of the supplier to the warehouse used by Entity A for storing inventory.

### **Analysis of the transactions**

Which of the transactions above warrant disclosure as related-party transactions under IAS 24.

- a. Notwithstanding the fact that Entity A purchases all its raw materials and parts from Entity B and is economically dependent on it, Entity B does not automatically become a related party. Thus for the purpose of IAS 24, purchases made from Entity B are not considered related-party transactions and hence would not need to be disclosed.
- b. 65% of the sales are to an entity owned by a “director”—Entity C (i.e., an entity controlled by a key management person), and 25% of the sales are made to an entity that Entity A has “significant influence” over. Thus both sales are to related parties as defined in IAS 24 and would need to be disclosed as such. The 10% of the sales to the company owned by the financiers does not qualify to be disclosed as related party’s transactions simply because the financier does not have any control or significant influence over Entity A.
- c. Even though Entity A and Entity F share one director, the two companies are not related and thus the transaction need not to be disclosed in Entity A’s financial statements..
- d. The interest-free loan to an entity owned by a director needs to be disclosed as a related-party transaction. The fact that it is interest-free may warrant disclosure because it may not be construed as an “arms-length transaction” since Entity A would not normally provide unrelated parties with interest-free loans.

### **Significant Influence**

The existence of the ability to exercise significant influence is an important concept in relation to this standard. It is one of the two criteria stipulated in the definition of a related party, which when present would, for the purposes of this standard, make one party related to another. In other words, for the purposes of this standard, if one party is considered to have the ability to exercise significant influence over another, then the two parties are considered to be related.

The existence of the ability to exercise significant influence may be evidenced in one or more of the following ways:

1. By representation on the board of directors of the other entity;
2. By one company having influence over a decision by the virtue of a casting vote at a meeting of directors or shareholders;
3. By participation in the policy-making process of the other entity;
4. By having material intercompany transactions between two entities;
5. By interchange of managerial personnel between two entities; or
6. By dependence on another entity for technical information.

Significant influence may be gained through agreement, by statute or by means of share ownership. Under the provisions of IAS 24, similar to the presumption of significant influence under IAS 28, an entity is deemed to possess the ability to exercise significant influence if it directly or indirectly through subsidiaries holds 20% or more of the voting power of another entity (unless it can be clearly demonstrated that despite holding such voting power the investor does not have the ability to exercise significant influence over the investee). Conversely, if an entity, directly or indirectly through subsidiaries, owns less than 20% of the voting power of another entity, it is presumed that the investor does not possess

the ability to exercise significant influence (unless it can be clearly demonstrated that the investor does have such an ability despite holding less than 20% of the voting power). Further, while explaining the concept of significant influence, IAS 28 also clarifies that “a substantial or majority ownership by another investor does not *necessarily* preclude an investor from having significant influence” (emphasis added).

**Example—Consideration of Subsidiaries, Associates and Joint Ventures.**

The following is a group structure of Entity A “The Parent.”

Entity A has a controlling interest in Entity B and C. Further the company has significant influence over an Associate (Entity D) whereas one of the subsidiaries (Entity C) has significant influence over another Associate (Entity E).

Entity A controls a Joint Venture (JV) together with a company called Capital Investors Inc.

**Analysis of the disclosures considerations**

In the Entity A’s separate financial statements, all the Subsidiaries, Associates and the Joint Ventures (JV) are all related parties. The joint venturer, Capital Investors Inc., doesn’t qualify to be disclosed as a related party.

In Entity B’s financial statements, The Parent, Entity C, the Associates and the JV are related parties.

In Entity C’s separate financial statements, The Parent, Entity B, the Associates and the JV are related parties.

In the financial statements of Associates D and E, The Parent and Subsidiaries and the JV are related parties. Associates D and E are not related to each other though.

## **DISCLOSURES**

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### **Financial Statement Disclosures**

IAS 24 recognizes that in many countries certain related-party disclosures are prescribed by law. In particular, transactions with directors, because of the fiduciary nature of their relationship with the entity, are mandated financial statement disclosures in some jurisdictions. In fact, corporate legislation in some countries goes further and requires certain disclosures which are even more stringent than the disclosure requirements under IAS 24, or under most national GAAP.

For example, under one regulation, in addition to the usual disclosures pertaining to related-party transactions, companies are required to disclose not just year-end balances that are due to or due from directors or certain other related parties, but are also required to disclose the highest balances for the period (for which financial statements are presented) which were due to or due from them to the corporate entity. Such a requirement may exist since in the absence of this disclosure, balances at year-end can be “cleaned up” (e.g., via short-term bank borrowings) and the artificially low amounts reported can provide a misleading picture to financial statement users regarding the real magnitude of such transactions and balances.

There is nothing in IAS 24 that prohibits supplemental information from being provided over and above the requirements of the standard. Commitment to a “substance over form” approach, with the goal of maximizing representational faithfulness and ensuring transparency of the financial reporting process would, indeed, make expanded disclosures appear all but mandatory. While many do seek to satisfy the mere letter of the requirements under IFRS, the “principles-based” approach of these standards would, it could easily be argued,

demand that preparers (and their auditors) undertake to comply with the spirit of the rules as well.

IAS 24 provides examples of situations where related-party transactions may lead to disclosures by a reporting entity in the period that they affect.

- Purchases or sales of goods (finished or unfinished, meaning work in progress).
- Purchases or sales of property and other assets.
- Rendering or receiving of services.
- Agency arrangements.
- Leasing arrangement.
- Transfer of research and development.
- License agreements.
- Finance (including loans and equity participation in cash or in kind).
- Guarantees and collaterals.
- Commitments linked to the occurrence or non-occurrence of particular events, including executory contracts (recognized and unrecognized).
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

The foregoing should not be considered an exhaustive list of situations requiring disclosure. As very clearly stated in the standard, these are only “examples of situations . . . which may lead to disclosures.” In practice, many other situations are encountered which would warrant disclosure. For example, a contract for maintaining and servicing computers, entered into with a subsidiary company, would need to be disclosed by the reporting entity in parent company financial statements.

### **Disclosure of Parent-Subsidiary Relationships**

IAS 24 requires disclosure of relationships between parent and subsidiaries irrespective of whether there have been transactions between the related parties. The name of the parent entity must be provided in the subsidiary’s financial statement disclosures; if the ultimate controlling party is a different entity, its name must be disclosed. One reason for this requirement is to enable users of the reporting entity’s financial statements to seek out the financial statements of the parent or ultimate controlling party for possible review. If neither of these produces consolidated financial statements available for public use, IAS 24 provides that the name of the “next most senior parent” that produces financial statements must be stated, in addition. These requirements are in addition to those set forth by IFRS 10, IFRS 11 and IAS 28.

To illustrate this point, consider the following example:

Apex, who owns 25% of Bellweather, and by virtue of share ownership has more than 20% of the voting power, would be considered to possess the ability to exercise significant influence over Bellweather. During the year, Apex entered into an agency agreement with Bellweather; however, no transactions took place during the year between the two companies based on the agency contract. Since Apex is considered a related party to Bellweather by virtue of the ability to exercise significant influence, rather than control (i.e., there is not a parent-subsidiary relationship), no disclosure of this related-party relationship would be needed under IAS 24. If, however, Apex owned 51% or more of the voting power of Bellweather it would thereby be considered related to Bellweather on the basis of control and disclosure of this relationship would be needed, irrespective of whether any transactions actually took place between them.

### Disclosures to Be Provided

Per IAS 24, if there have been transactions between related parties, the reporting entity should disclose:

1. The nature of the related-party transaction; and
2. Information about transactions and outstanding balances necessary to understand the potential effect of the relationship on the financial statements. At a minimum the following disclosure shall be made:
  - a. The amount of the transaction;
  - b. Amount of outstanding balances and their terms and conditions, including whether they are secured and details of any guarantees given or received;
  - c. Provision for doubtful debts related to the amount of the outstanding balances;
  - d. Any expense recognized during the period in respect of bad or doubtful debts due from the related parties.

The disclosures required are to be made *separately* for each of the following categories:

1. The parent;
2. Entities with joint control or significant influence over the entity;
3. Subsidiaries;
4. Associates;
5. Joint venture in which the entity is a venturer;
6. Key management personnel of the entity or its parent; and
7. Other related parties.

### *Arm's-length transaction price assertions*

The assertion that related-party transactions were made at terms that are normal or that the related-party transactions are at arm's-length can be made only if it can be supported. It is presumed that it would rarely be prudent to make such an assertion. The default presumption is that related-party transactions are not *necessarily* conducted on arm's-length terms, which is not taken to imply that transactions were conducted on other bases, either.

Thus, for example, when an entity purchases raw materials amounting to €5 million from an associated company, these are at normal commercial terms (which can be supported, e.g., by competitive bids), and these purchases account for 75% of its total purchases for the year, the following disclosures would seem appropriate:

During the year, purchases amounting to €5 million were made from an associated company. These purchases were made at normal commercial terms, at prices equivalent to those offered by competitive unrelated vendors. At December 31, 20XX, the balance remaining outstanding and owed to this associated company amounted to €2.3 million.

Note that the obtaining of sufficient competent evidence to support an assertion that terms, including prices, for related-party transactions were equivalent to those which would have prevailed for transactions with unrelated parties may be difficult. For example, if the reporting entity formerly purchased from multiple unrelated vendors but, after acquiring a captive source of supply, moves a large portion of its purchases to that vendor, even if prices are the same as had been formerly negotiated with the many unrelated suppliers, this might not warrant an assertion such as the above. The reason is that, with 75% of all purchases



being made with this single, related-party supplier, it might not be valid to compare those prices with the process previously negotiated with multiple vendors each providing only a smaller fraction of the reporting entity's needs. Had a large (almost single-source) supply arrangement been executed with any one of the previous suppliers, it might have been possible to negotiate a lower schedule of prices, making comparison of former prices paid for small purchases inapplicable to support this assertion.

### ***Aggregation of disclosures***

IAS 24 requires that items of a similar nature may be disclosed in the aggregate. However, when separate disclosure is necessary for an understanding of the effects of the related-party transactions on the financial statements of the reporting entity, aggregation would not be appropriate.

A good example of the foregoing is an aggregated disclosure of total sales made during the year to a number of associated companies, instead of separately disclosing sales made to each associated company. On the other hand, an example of separate disclosure (as opposed to aggregated disclosure) is the disclosure of year-end balances due from various related parties disclosed by category (e.g., advances to directors, associated companies, etc.). In the latter case, it makes sense to disclose separately by categories of related parties, instead of aggregating all balances from various related parties together and disclosing, say, the total amount due from all related parties as one amount, since the character of the transactions could well be at variance, as might be the likelihood of timely collection. In fact, separate disclosure in this case seems necessary for an understanding of the effects of related-party transactions on the financial statements of the reporting entity.

IAS 24 specifically cites other IFRS which also establish requirements for disclosures of related-party transactions. These include:

- IFRS 10, which requires disclosure of a listing of significant subsidiaries.
- IAS 28, which requires disclosure of a listing of significant associates.
- IFRS 11, which requires disclosure of a listing of interests in significant joint arrangements.

### ***Compensation***

A controversial topic is the disclosure of details regarding management compensation. In some jurisdictions, such disclosures (at least for the upper echelon of management) are required, but in other instances these are secrets closely kept by the reporting entities. The IASB considered deleting these disclosures, given privacy and other concerns, and the belief that other "approval processes" (i.e., internal controls) regulated these arrangements, which therefore would not be subject to frequent abuse. However, these disclosures were maintained in the revised standard because these are deemed relevant for decision making by statement users and are clearly related-party transactions.

The reporting entity is required to disclose key management personnel compensation in total and for each of the following categories:

- Short-term employee benefits;
- Post-employment benefits;
- Other long-term benefits;
- Terminal benefit; and
- Share-based payment.

## Comparatives

IAS 24 does not address the basis on which comparative financial information should be presented. Often, challenges arise in respect of parties that are related in one period but not in the other. However, under the objectives of IAS 24 as set out above, it is recommended that disclosures be provided for transactions and balances with parties that were related during the respective years presented.

For example, A sold goods to B in 20XX and 20XX-1. In 20XX, A acquired a 25% interest in B. Related party transactions would only be disclosed for the 20XX financial statements because the transactions in 20XX-1 were not carried out and influenced by relationship as defined under IAS 24.

On the other hand, if A had a 25% interest in B in 20XX-1 which was disposed of at the end of 20XX-1, the transactions for 20XX-1 should be disclosed under IAS 24 but not the transactions for 20XX.

## Government-Related Entities

The reporting entity is exempt from the disclosure requirements for related-party transactions and outstanding balances, including commitments for the following entities:

1. A government that has control, joint control or significant influence over the reporting entity; and
2. Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

If the exemption is applicable, the reporting entity must disclose the following:

1. The name of the government and the nature of its relationship with the reporting entity (i.e., control, joint control or significant influence).
2. The following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related-party transactions on its financial statements:
  - a. The nature and amount of each individually significant transaction; and
  - b. For other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

Judgement is used to determine the level of detail to be disclosed for significant transactions. The reporting entity should consider the closeness of the related-party relationship and the following factors in establishing the level of significance of the transaction:

1. Significance in terms of size.
2. Whether or not the transaction was carried out on non-market-related terms.
3. Whether or not the transaction was outside the entity's normal day-to-day business operations, such as the purchase and sale of businesses.
4. Whether or not the transaction was disclosed to regulatory or supervisory authorities.
5. Whether or not the transaction was reported to senior management.
6. Whether or not the transaction was subject to shareholder approval.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES

**Exemplum Reporting PLC**  
**Financial statements**  
**For the year ended 31 December 20XX**

The group's investments in subsidiaries, associates and joint ventures have been disclosed in notes XX and XX. The group is controlled by XYZ plc. XYZ plc is also the group's ultimate controlling company

Transactions:

Relationship	Sales of goods		Purchase of goods		Related party		Amounts owed to related party		Amount owed by related party	
	20XX	20XX-1	20XX	20XX-1	20XX	20XX-1	20XX	20XX-1	20XX	20XX-1
Parent	X	X	X	X	X	X	X	X	X	X
Associates	X	X	X	X	X	X	X	X	X	X
Joint venture	X	X	X	X	X	X	X	X	X	X
Key management personnel	-	-	-	-	X	X	X	X	X	X

Amounts owed to and by related parties are unsecured, interest-free, and have 110 fixed terms of repayment. The balances will be settled in cash. No guarantees have been given or received. No provisions for doubtful debts have been raised against amounts outstanding, and no expense has been recognized during the period in respect of bad or doubtful debts due from related parties.

	20XX	20XX-1
Key management personnel compensation:		
Short-term employee benefits	X	X
Post-employment benefits	X	X
Other long-term benefits	X	X
Termination benefits	X	X
Share based payments	X	X
Dividends	X	X
	X	X

## US GAAP COMPARISON

Similar to IFRS, US GAAP requires disclosure of related-party transactions and relationships so users can assess the impact of such arrangements on the financial statements. However, unlike IFRS, disclosures about relationships with government bodies are subject to the general disclosures of other topics.

Transactions between related parties, with some exceptions, whether reflected in the financial statements or not (e.g., exchange of the services between subsidiaries under common control of a parent that are not reflected in the books of record) are disclosed. Exceptions are compensation, expense allowances or similar items in the ordinary course of business. However, receivables from employees, officers and affiliated entities must be presented separately from others.

The disclosures for related-party transactions are the nature of the relationships involved, description of the transactions, the dollar amount of such transactions, amounts due to or from related-parties, and the terms. The name of the related party should be

included if necessary to an understanding of the relationship. Additionally, if an entity is a member of a group that is under common control and the existence of that control could result in operating results or financial position substantially different from those that would have resulted without that relationship, the disclosures must include the nature of the relationship.

Amounts disclosed can be aggregated by type provided that doing so does not obscure the nature or amount with a significant related party. General disclosures cannot imply that transactions with related parties are made on an arm's-length basis unless it can be substantiated.

**Defined contribution plans.** Retirement benefit plans whereby retirement benefits to be paid to plan participants are determined by contributions to a fund together with investment earnings thereon.

**Funding.** The transfer of assets to a separate entity (distinct from the employer's entity), the "fund," to meet future obligations for the payment of retirement benefits.

**Net assets available for benefits.** The assets of a retirement benefit plan less its liabilities other than the actuarial present value of promised retirement benefits.

**Participants.** The members of a retirement benefit plan and others who are entitled to benefits under the plan.

**Retirement benefit plans.** Formal or informal arrangements based upon which an entity provides benefits for its employees on or after termination of service, which are usually referred to as "termination benefits." These could take the form of annual pension payments or lump-sum payments. Such benefits, or the employer's contributions towards them, should however be determinable or possible of estimation in advance of retirement, from the provisions of a document (i.e., based on a formal arrangement) or from the entity's practices (which is referred to as an informal arrangement).

**Vested benefits.** Entitlements, the rights to which, under the terms of a retirement benefit plan, are not conditional on continued employment.

## SCOPE

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IAS 26 should be applied in accounting and reporting by retirement benefit plans. The terms of a retirement plan may require that the plan present an annual report; in some jurisdictions this may be a statutory requirement. IAS 26 does not establish a mandate for the publication of such reports by retirement plans. However, if such reports are prepared by a retirement plan, then the requirements of this standard should be applied to them.

IAS 26 regards a retirement benefit plan as a separate entity, distinct from the employer of the plan's participants. It is noteworthy that this standard also applies to retirement benefit plans that have sponsors other than the employer (e.g., trade associations or groups of employers). Furthermore, this standard deals with accounting and reporting by retirement benefit plans to all participants as a group; it does not deal with reports to individual participants with respect to their retirement benefit entitlements.

The standard applies the same basis of accounting and reporting to informal retirement benefit arrangements as it applies to formal retirement benefit plans. It is also worthy of mention that this standard applies whether or not a separate fund is created and regardless of whether there are trustees. The requirements of this standard also apply to retirement benefit plans with assets invested with an insurance company, unless the contract with the insurance company is in the name of a specified participant or a group of participants and the responsibility is solely of the insurance company. This standard does not deal with other forms of employment benefits such as employment termination indemnities, deferred compensation arrangements, long-service leave benefits, special early retirement or redundancy plans, health and welfare plans or bonus plans. Government social security-type arrangements are also excluded from the scope of this standard.

## DEFINED CONTRIBUTION PLANS

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Retirement benefit plans are usually described as being either defined contribution or defined benefit plans. When the quantum of the future benefits payable to the retirement

benefit plan participants is determined by the contributions paid by the participants' employer, the participants, or both, together with investment earnings thereon, such plans are defined contribution plans. Defined benefit plans, by contrast, promise certain benefits, often determined by formulae which involve factors such as years of service and salary level at the time of retirement, without regard to whether the plan has sufficient assets; thus the ultimate responsibility for payment (which may be guaranteed by an insurance company, the government or some other entity, depending on local law and custom) remains with the employer. In rare circumstances, a retirement benefit plan may contain characteristics of both defined contribution and defined benefit plans; such a hybrid plan is deemed to be a defined benefit plan for the purposes of this standard.

IAS 26 requires that the report of a defined contribution plan contain a statement of the net assets available for benefits and a description of the funding policy. In preparing the statement of the net assets available for benefits, the plan investments should be carried at fair value, which for marketable securities would be market value. In case an estimate of fair value is not possible, disclosure is required of the reason as to why fair value has not been used. As a practical matter, most plan assets will have determinable market values, since the plans' trustees' discharge of their fiduciary responsibilities will generally mandate that only marketable investments be held.

An example of a statement of net assets available for plan benefits, for a defined contribution plan, is set forth below.

**XYZ Defined Contribution Plan**  
**Statement of Net Assets Available for Benefits**  
**December 31, 20XX**  
**(€000)**

<i>Assets</i>	
<i>Investments at fair value</i>	
Government securities	€ 5,000
Municipal bonds	3,000
Local equity securities	3,000
Foreign equity securities	3,000
Local debt securities	2,000
Foreign corporate bonds	2,000
Other	<u>1,000</u>
Total investments	<u>19,000</u>
<i>Receivables</i>	
Amounts due from stockbrokers on sale of securities	15,000
Accrued interest	5,000
Dividends receivable	<u>2,000</u>
Total receivables	<u>22,000</u>
<i>Cash</i>	
	<u>5,000</u>
Total assets	<u><b>€46,000</b></u>
<i>Liabilities</i>	
<i>Accounts payable</i>	
Amounts due to stockbrokers on purchase of securities	€10,000
Benefits payable to participants—due and unpaid	<u>11,000</u>
Total accounts payable	<u>21,000</u>
<i>Accrued expenses</i>	
	<u>11,000</u>
Total liabilities	<u><b>€32,000</b></u>
Net assets available for benefits	<u><b>€14,000</b></u>

## DEFINED BENEFIT PLANS

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When amounts to be paid as retirement benefits are determined by reference to a formula, usually based on employees' earnings and/or years of service, such retirement benefit plans are defined benefit plans. The key factor is that the benefits are fixed or determinable, without regard to the adequacy of assets which may have been set aside for payment of the benefits. This contrasts to the defined contribution plans approach, which is to provide the workers, upon retirement, with the amounts which have been set aside, plus or minus investment earnings or losses which have been accumulated thereon, however great or small that amount may be.

The standard requires that the report of a defined benefit plan should contain *either*:

1. A statement that shows:
  - a. The net assets available for benefits;
  - b. The actuarial present value of promised retirement benefits, distinguishing between vested and non-vested benefits; and
  - c. The resulting excess or deficit;

*or*

2. A statement of net assets available for benefits including *either*,
  - a. A note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested and non-vested benefits; or
  - b. A reference to this information in an accompanying actuarial report.

IAS 26 recommends, but does not mandate, that in each of the three formats described above, a trustees' report in the nature of a management or directors' report and an investment report may also accompany the statements.

The standard does not make it incumbent upon the plan to obtain annual actuarial valuations. If an actuarial valuation has not been prepared on the date of the report, the most recent valuation should be used as the basis for preparing the financial statement. The date of the valuation used should be disclosed. Actuarial present values of promised benefits should be based either on current or projected salary levels; whichever basis is used should be disclosed. The effect of any changes in actuarial assumptions that had a material impact on the actuarial present value of promised retirement benefits should also be disclosed. The report should explain the relationship between actuarial present values of promised benefits, the net assets available for benefits and the policy for funding the promised benefits.

As in the case of defined contribution plans, investments of a defined benefit plan should be carried at fair value, which for marketable securities, would be market value.

The following are examples of the alternative types of reports prescribed for a defined benefit plan:

**ABC Defined Benefit Plan**  
**Statement of Net Assets Available for Benefits, Actuarial Present Value of**  
**Accumulated**  
**Retirement Benefits and Plan Excess or Deficit**  
**December 31, 20XX**  
**(€000)**

## 1. Statement of net assets available for benefits

**Assets***Investments at fair value*

Government securities	€ 50,000
Municipal bonds	30,000
Local equity securities	30,000
Foreign equity securities	30,000
Local debt securities	20,000
Foreign corporate bonds	20,000
Other	<u>10,000</u>
Total investments	<u>€190,000</u>

*Receivables*

Amounts due from stockbrokers on sale of securities	150,000
Accrued interest	50,000
Dividends receivable	<u>20,000</u>
Total receivables	<u>220,000</u>

*Cash*

Total assets	<u>460,000</u>
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**Liabilities***Accounts payable*

Amounts due to stockbrokers on purchase of securities	100,000
Benefits payable to participants—due and unpaid	<u>110,000</u>
Total accounts payable	<u>210,000</u>

*Accrued expenses*

Total liabilities	<u>320,000</u>
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Net assets available for benefits	<u>€140,000</u>
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## 2. Actuarial present value of accumulated plan benefits

Vested benefits	€100,000
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Non-vested benefits	<u>20,000</u>
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Total	<u>€120,000</u>
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3. Excess of net assets available for benefits over actuarial present value of accumulated plan benefits	€ 20,000
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**ABC Defined Benefit Plan**  
**Statement of Changes in Net Assets Available for Benefits**  
**December 31, 20XX**  
**(€000)**

*Investment income*

Interest income	€ 40,000
Dividend income	10,000
Net appreciation (unrealized gain) in fair value of investments	<u>10,000</u>
Total investment income	<u>60,000</u>

*Plan contributions*

Employer contributions	50,000
Employee contributions	<u>50,000</u>
Total plan contributions	<u>100,000</u>



Total additions to net asset value	<u>160,000</u>
<i>Plan benefit payments</i>	
Pensions (annual)	30,000
Lump sum payments on retirement	30,000
Severance pay	10,000
Commutation of superannuation benefits	<u>15,000</u>
Total plan benefit payments	<u>85,000</u>
Total deductions from net asset value	<u>85,000</u>
Net increase in asset value	<u>75,000</u>
Net assets available for benefits	
Beginning of year	<u>65,000</u>
End of year	<u>€140,000</u>

## DISCLOSURES

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IAS 26 requires that the reports of a retirement benefit plan, both defined benefit plans and defined contribution plans, should also contain the following information:

1. A statement of changes in net assets available for benefits;
2. A summary of significant accounting policies; and
3. A description of the plan and the effect of any changes in the plan during the period.

Reports provided by retirement benefits plans may include the following, if applicable:

1. A statement of net assets available for benefits disclosing:
  - a. Assets at the end of the period suitably classified;
  - b. The basis of valuation of assets;
  - c. Details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security;
  - d. Details of any investment in the employer; and
  - e. Liabilities other than the actuarial present value of promised retirement benefits;
2. A statement of changes in net assets available for benefits showing the following:
  - a. Employer contributions;
  - b. Employee contributions;
  - c. Investment income such as interest and dividends;
  - d. Other income;
  - e. Benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump-sum payments);
  - f. Administrative expenses;
  - g. Other expenses;
  - h. Taxes on income;
  - i. Profits and losses on disposal of investments and changes in value of investments; and
  - j. Transfers from and to other plans;
3. A description of the funding policy;
4. For defined benefit plans, the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the

benefits promised under the terms of the plan, on service rendered to date and using either current salary levels or projected salary levels. This information may be included in an accompanying actuarial report to be read in conjunction with the related information; and

5. For defined benefit plans, a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

According to the standard, since the report of a retirement benefit plan contains a description of the plan, either as part of the financial information or in a separate report, it may contain the following:

1. The names of the employers and the employee groups covered;
2. The number of participants receiving benefits and the number of other participants, classified as appropriate;
3. The type of plan—defined contribution or defined benefit;
4. A note as to whether participants contribute to the plan;
5. A description of the retirement benefits promised to participants;
6. A description of any plan termination terms; and
7. Changes in items 1 through 6 during the period covered by the report.

Furthermore, it is not uncommon to refer to other documents that are readily available to users and in which the plan is described, and to include only information on subsequent changes in the report.

## US GAAP COMPARISON

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The US GAAP codification has separate sections for the reporting by defined benefit plans (ASC 960), defined contribution plans (ASC 962) and health and welfare plans (ASC 965). Like IFRS, actuarial measurement of the obligation is necessary and shall include estimates of participant vesting.

The obligations for these three types of plans must include future expected increases in salary rates (if applicable). There is no option as there is under IFRS to choose current salary levels. US GAAP, like IFRS, includes future increases in benefits costs. Plan assets are recorded at fair value with reductions for costs to sell. Benefit-responsive insurance contracts are reported both at fair value and contract value.

The accounting for benefit plans under US GAAP is heavily influenced by US regulations, primarily the Employment Retirement and Income Security Act of 1974 (ERISA). Certain disclosures are required only because ERISA mandates them, although the plan need not be under the jurisdiction of ERISA. Additionally, certain US-government-defined plans are specifically presented in the financial statements of the plans.

Generally, all three types of plans require the following statements:

- A statement that includes information regarding the net assets available for benefits as of the end of the plan year.
- A statement that includes information regarding the changes during the year in the net assets available for benefits.
- Except for defined contribution plans, information regarding the actuarial present value of accumulated plan benefits as of either the beginning or end of the plan year is required.

some cases accounting for over 50% of gross national product, logic would suggest that comprehensive systems of financial reporting for business entities cannot be deemed complete while excluding so large a segment of the economy.

A review of published financial statements for agriculture-related entities would have revealed the consequences of the lack of a single method of accounting. A wide range of methods and principles has been applied to such businesses as forest products, livestock and grain production.

For example, some forest products companies have accounted for timberlands at original cost, charging depreciation only to the extent of net harvesting, with reforestation costs charged to expense as incurred. Others in the same industry capitalized reforestation costs and even carrying costs, and charged depletion on a units-of-production basis. Still others have been valuing forest lands at the net present value of expected future cash flows. This wide disparity obviously has impaired users' ability to gauge the relative performance of entities operating within a single industry group, hindering investment and other decision making by them.

<b>Sources of IFRS</b> <i>IAS 41</i>
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## SCOPE

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IAS 41 applies to the following when they relate to agricultural activity: biological assets, agricultural produce at the point of harvest and government grants, as those are the aspects of agriculture that have unique characteristics. The accounting for assets such as inventories and plant and equipment will be guided by such existing standards as IAS 2 and 16. In other words, once the biological transformation process is complete (e.g., when grain is harvested, fruit is picked, animals are slaughtered or trees are felled), the specialized accounting principles imposed on agriculture will cease to apply.

The standard does not apply to the following

- Land related to agricultural activity;
- Intangible assets related to agriculture activity;
- Leased biological assets held by a lessee under an operating lease;
- Agricultural produce after the point of harvest.

The above items are all accounted for in terms of other IFRS.

## DEFINITIONS OF TERMS

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**Active market.** Market for which all these conditions exist: the items traded within the market are homogeneous; willing buyers and sellers can normally be found at any time; and prices are available to the public.

**Agricultural activity.** Managed biological transformation of biological assets into agricultural produce for sale, consumption, further processing, or into other biological assets.

**Agricultural land.** Land used directly to support and sustain biological assets in agricultural activity; however, the land itself is not a biological asset.

**Agricultural produce.** The harvested product of the entity's biological assets awaiting sale, processing or consumption.

**Bearer biological assets.** Those which bear agricultural produce for harvest. The biological assets themselves are not the primary agricultural produce, but rather are self-regenerating (such as sheep raised for wool production; fruit trees).

**Biological assets.** Living plants and animals controlled by the entity as a result of past events. Control may be through ownership or through another type of legal arrangement.

**Biological transformation.** The processes of growth, degeneration, production and procreation, which cause qualitative and quantitative changes in living organisms and the generation of new assets in the form of agricultural produce or additional biological assets of the same class.

**Carrying amount.** Amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation or amortization and accumulated impairment losses thereon.

**Consumable biological assets.** Those which are to be harvested as the primary agricultural produce, such as livestock intended for meat production, annual crops, and trees to be felled for pulp.

**Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Group of biological assets.** An aggregation of similar living animals or plants. For instance, a herd, flock, etc., that is managed jointly to ensure that the group is sustainable on an ongoing basis.

**Harvest.** The detachment of agricultural produce from the biological asset, the removal of a living plant from agricultural land for sale and replanting, or the cessation of a biological asset's life processes.

**Immature biological assets.** Those that are not yet harvestable or able to sustain regular harvests.

**Mature biological assets.** Those that are harvestable or able to sustain regular harvest. Consumable biological assets are mature when they have attained harvestable specifications; bearer biological assets are mature when they are able to sustain regular harvests.

**Net realizable value.** Estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.

## IDENTIFICATION

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Agriculture is defined as essentially the management of the biological transformation of plants and animals to yield produce for consumption or further processing. The term agriculture encompasses livestock, forestry, annual and perennial cropping, orchards, plantations and aquaculture. Agriculture is distinguished from "pure exploitation," where resources are simply removed from the environment (e.g., by fishing or deforestation) without management initiatives such as the operation of hatcheries, reforestation or other attempts to manage their regeneration. IAS 41 does not apply to pure exploitation activities, nor does it apply to agricultural produce, which is harvested and is thus a non-living product of the biological assets. The standard furthermore does not govern accounting for agriculture produce which is incorporated in further processing, as occurs in integrated agribusiness entities that involve activities which are not unique to agriculture.

IAS 41 sets forth a three-part test or set of criteria for agricultural activities. First, the plants or animals which are the object of the activities must be alive and capable of transformation. Second, the change must be managed, which implies a range of activities

(e.g., fertilizing the soil and weeding in the case of crop growing; feeding and providing health care in the instance of animal husbandry; etc.). Third, there must be a basis for the measurement of change, such as the ripeness of vegetables, the weight of animals, circumference of trees and so forth. If these three criteria are all satisfied, the activity will be impacted by the financial reporting requirements imposed by IAS 41.

Biological assets are the principal assets of agricultural activities, and they are held for their transformative potential. This results in two major types of outcomes: the first may involve asset changes—as through growth or quality improvement, degeneration or procreation. The second involves the creation of separable products initially qualifying as agricultural produce. The management of the biological transformation process is the distinguishing characteristic of agricultural activities.

Biological assets often are managed in groups, as exemplified by herds of animals, groves of trees and fields of crops. To be considered a group, however, the components must be homogeneous in nature and there must further be homogeneity in the activity for which the group is deployed. For example, cherry trees maintained for their production of fruit are not in the same group as cherry trees grown for lumber.

IAS 41 applies to forests and similar regenerative resources excluded from IAS 16; producers' inventories of livestock, agriculture and forest products, including those excluded from IAS 2, to the extent they are to be measured at net realizable value; and natural increases in herds and agricultural and forest products excluded from IAS 18.

## RECOGNITION AND MEASUREMENT

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### Basic Principles of IAS 41

IAS 41 applies to all entities which undertake agricultural activities. Animals or plants are to be recognized as assets when it is probable that the future economic benefits associated with the asset will flow to the reporting entity, and when the cost or value to the entity can be measured reliably. The standard also governs the initial measurement of agricultural produce, which is the end product of the biological transformation process; it furthermore guides the accounting for government grants pertaining to agricultural assets.

The most important feature of the standard is the requirement that biological assets are to be measured at their respective fair values as of each date of the statements of financial position. The imperative to deploy fair value accounting springs from the fact that there are long production periods for many crops (an extreme being forests under management for as long as thirty years before being harvested) and, even more typically, for livestock. In the absence of fair value accounting with changes in value being reported in operating results, the entire earnings of a long-term production process might only be reported at lengthy intervals, which would not faithfully represent the underlying economic activities being carried out. This is entirely analogous to long-term construction projects, for which percentage-of-completion accounting is commonly prescribed, for very similar reasons.

Historical cost based accounting, with revenue to be recognized only upon ultimate sale of the assets, would often result in a gross distortion of reported results of operations, with little or no earnings being reflected in some periods, or even losses being reported to the extent that production expenses are not inventoried. Other periods—when trees are harvested, for example—would reflect substantial reported profits. Thus, the use of historical costs based on completed transactions is no longer deemed meaningful in the case of agricultural activities.

Not only are such periodic distortions seen as being misleading, but it also has been concluded that each stage of the biological transformation process has significance. Each stage (growth, degeneration, procreation and production) is now seen as contributing to the expected economic benefits to be derived from the biological assets. Unless a fair value model were employed for financial reporting, there would be a lack of explicit recognition (in effect, no matching) of the benefits associated with each of these discrete events. Furthermore, this recognition underlines the need to apply the same measurement concept to each stage in the life cycle of the biological assets; for example, for live weight change, fleece weight change, aging, deaths, lambs born and wool shorn, in the case of a flock of sheep.

The obvious argument in favour of historical cost-based measures derives from the superior reliability of that mode of measurement. With completed transactions, there is no imprecision due to the inherently subjective process of making or obtaining fair value assessments. By contrast, superior relevance is the strongest argument for current value measurement schemes. The IASB ultimately identified fair value as having the best combination of attributes for the determination of agriculture-related earnings. The IASB was particularly influenced by the market context in which agriculture takes place and the transformative characteristics of biological assets, and it concluded that fair value would offer the best balance of relevance, reliability, comparability and understandability.

The IASB also concluded that annual determinations of fair value would be necessary to properly portray the combined impact of nature and financial transactions for any given reporting period. Less frequent measurements were rejected because of the continuous nature of biological transformations, the lack of direct correlation between financial transactions and the different outcomes arising from biological transformation (thus, the former could not serve as surrogate indicators of the latter during off periods), the volatilities which often characterize natural and market environments affecting agriculture, and the fact that market-based measures are in fact readily available.

Notwithstanding the fact that historical cost is rejected as being meaningful in this context, the IASB agreed that an exception should exist for those circumstances when fair value cannot be reliably estimated. In such instances, historical costs will continue to be employed instead.

### **Determining Fair Values**

The primary determinant of fair value is observable market prices, just as it is for financial instruments having active markets (as defined in IAS 32, discussed at length in Chapter 24). Chapter 25 discusses fair value measurements under IFRS 13, *Fair Value Measurement*, in more depth. The required use of “farm gate” market prices will reflect both the “as is” and “where is” attributes of the biological assets. That is, the value is meant to pertain to the assets as they exist, where they are located, in the condition they are in as of the measurement (statement of financial position) date. They are not hypothetical values, as for instance hogs when delivered to the slaughterhouse. Where these “farm gate” prices are not available, market values will have to be reduced by transaction costs, including transport, to arrive at net market values which would equate to fair values as intended by IAS 41.

In the case of products for which market values might not be readily available, other approaches to fair value determination will have to be employed. This is most likely to become an issue where market values exist but, due to market imperfections, are not deemed to be useful. For example, when access to markets is restricted or unduly influenced by temporary monopoly or monopsony conditions, or when no market actually exists as of the

date of the statement of financial position, alternative measures will be called for. In such circumstances, it might be necessary to refer to such indicators as the most recent market prices for the class of asset at issue, market prices for similar assets (e.g., different varieties of the same crop), sector benchmarks (e.g., relating value of a dairy farm to the kilograms of milk solids or fat produced), net present value of expected future cash flows discounted at a risk-class rate, or net realizable values for short-cycle products for which most growth has already occurred. Last and probably least useful would be historical costs, which might be particularly suited to biological assets that have thus far experienced little transformation.

One practical problem arises when an indirect method of valuation implicitly values both the crop and the land itself, taken together as a whole. IAS 41 indicates that such valuations must be allocated to the different assets to give a better indication of the future economic benefits each will confer. If a combined market price, for example, can be obtained for the land plus the immature growing crops situated thereon, and a quotation for the land alone can also be obtained, this will permit a fair value assessment of the immature growing crops (while the land itself will generally be presented on the statement of financial position at cost, not fair value, under IAS 16). Another technique would involve the subdivision of the assets into classes based on age, quality or other traits, and the valuation of each subgroup by reference to market prices. While these methods may involve added effort, IAS 41 concludes that the usefulness of the resulting financial statements will be materially enhanced if this is done.

Increases in fair value due to the growth of the biological asset is only one-half of the accounting equation, of course, since there will normally have been cost inputs incurred to foster the growth (e.g., applications of fertilizer to the fields, etc.). Under the provisions of IAS 41, costs of producing and harvesting biological assets are to be charged to expense as incurred. This is necessary, since if costs were added to the assets' carrying amount (analogous to interest on borrowings in connection with long-term construction projects) and the assets were then also adjusted to fair value, there would be risk of double-counting cost or value increases. As mandated, however, value increases due to either price changes or growth, or both, will be taken into current income, where costs of production will be appropriately matched against them, resulting in a meaningful measure of the net result of periodic operations.

### **Recognition and Measurement**

The recognition and measurement requirements of IAS 41 are as follows:

1. Biological assets are to be measured on initial recognition and at the end of each reporting period at their fair value, less estimated costs to sell, except where fair value cannot be measured reliably. In which case it is valued at its historical cost less any accumulated depreciation and accumulated impairment losses.
2. Agricultural produce harvested from an entity's biological assets should be measured at fair value less estimated costs to sell at the point of harvest. That amount effectively becomes the cost basis, to which further processing costs may be added, as the conditions warrant, with accounting thereafter guided by IAS 2, *Inventories*, or other applicable standard.
3. The presumption is that fair value can be measured reliably for a biological asset. That presumption can be rebutted, only at the time of initial recognition, for a biological asset for which market-determined prices or values are not available and

for which alternative estimates of fair value are determined to be clearly unreliable. Once the fair value of such a biological asset becomes reliably measurable, it must be measured at its fair value less estimated costs to sell.

4. If an active market exists for a biological asset or for agricultural produce, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an active market does not exist, however, the reporting entity should use market-determined prices or values, such as the most recent market transaction price, when available.
5. Under certain circumstances, market-determined prices or values may not be available for an asset, as it exists in its current condition. In these circumstances, the entity should use the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate, in determining fair value.
6. The gain or loss which is reported upon initial recognition of biological assets, and also those arising from changes in fair value less estimated point-of-sales costs should be included in net profit or loss for the period in which the gain or loss arises. That is, these are reported in current period results of operations, and not taken directly into equity.
7. The gain or loss arising from the initial recognition of agricultural produce should be included in net profit or loss for the period in which it arises.
8. Land is to be accounted for under IAS 16, *Property, Plant, and Equipment*, or IAS 40, *Investment Property*, as is appropriate under the circumstances. Biological assets that are physically attached to land are recognized and measured at their fair value less estimated point-of-sales costs, separately from the land.
9. If the entity receives an unconditional government grant related to a biological asset measured at its fair value less estimated point-of-sales costs, the grant should be recognized as income when it first becomes receivable. If the grant related to a biological asset measured at its fair value less estimated costs to sell is conditional, including grants which require an entity not to engage in specified agricultural activity, the grant should be recognized in income when the conditions attaching to it are first met.
10. For government grants pertaining to biological assets which are measured at cost less accumulated depreciation and any accumulated impairment losses, IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, should be applied. (See Chapter 21.)
11. Some contracts for the sale of biological assets or agricultural produce are not within the scope of IAS 39, *Financial Instruments: Recognition and Measurement*, because the reporting entity expects to deliver the commodity, rather than settle up in cash. Under IAS 41, such contracts are to be measured at fair value until the biological assets are sold or the produce is harvested.

### **Agricultural Produce (Measurement)**

Agricultural produce is distinguished from biological assets and is not to be measured at fair value other than at the point of harvest, which is the point where biological assets become agricultural produce. For example, when crops are harvested they become agricultural produce and are initially valued at the fair value as of the date of harvest, at the location of harvest (i.e., the value of harvested crops at a remote point of delivery would not be a pertinent measure). If there has been a time interval between the last valuation and the



harvest, the value as of the harvest date should be determined or estimated; any increase or decrease since the last valuation would be taken into earnings.

## PRESENTATION AND DISCLOSURES

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### Financial Statement Presentation

#### *Statement of Financial Position*

IAS 41 requires that the carrying amount of biological assets be presented separately on the face of the statement of financial position (i.e., not included with other, non-biological assets). Preparers are encouraged to describe the nature and stage of production of each group of biological assets in narrative format in the notes to the financial statements, optionally quantified. Consumable biological assets are to be differentiated from bearer assets, with further subdivisions into mature and immature subgroups for each of these broad categories. The purpose of these disclosures is to give the users of the financial statements some insight into the timing of future cash flows, since the mature subgroups will presumably be realized through market transactions in the near future, and the pattern of cash flows resulting from bearer assets differs from those deriving from consumables.

#### *Statement of Profit or Loss and Other Comprehensive Income*

The changes in fair value should be presented on the face of the statement of profit or loss and other comprehensive income, ideally broken down between groups of biological assets. However, group level detail may be reserved to the notes to the financial statements.

IAS 1 permits the presentation of expenses in accordance with either a natural classification (e.g., materials purchases, depreciation, etc.) or a functional basis (cost of sales, administrative, selling, etc.). The draft standard on agriculture had urged that the natural classification of income and expenses be adopted for the statement of profit or loss and other comprehensive income. Sufficient detail is to be included in the face of the statement of profit or loss and other comprehensive income to support an analysis of operating performance. However, these are recommendations, not strict requirements.

#### *Disclosures*

IAS 41 establishes disclosure requirements for biological assets measured at cost less any accumulated depreciation and any accumulated impairment losses (i.e., for those exceptional biological assets which are **not** being carried at fair value). The disclosures are as follows:

1. A separate reconciliation of changes in the carrying amount of those biological assets;
2. A description of those biological assets;
3. An explanation of why fair value cannot be measured reliably;
4. A statement of the range of estimates within which fair value is highly likely to lie (if this is possible to give);
5. The amount of any gain or loss recognized on disposal of the biological assets;
6. The depreciation method used;
7. The useful lives or the depreciation rates used; and
8. The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period.

In addition to the foregoing, the following disclosures are required:

- If the fair value of biological assets previously measured at cost less any accumulated depreciation and any accumulated impairment losses subsequently becomes reliably measurable,
- The reporting entity must disclose a description of the biological assets,
- An explanation of how fair value has become reliably measurable, and the effect of the change in accounting method.

Furthermore an entity shall present a reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the current period. The reconciliation shall include:

1. The gain or loss arising from changes in fair value less costs to sell;
2. Increases due to purchases;
3. Decreases attributable to sales and biological assets classified as held-for-sale (or included in a disposal group that is classified as held-for-sale) in accordance with IFRS 5;
4. Decreases due to harvest;
5. Increases resulting from business combinations;
6. Net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity; and
7. Other changes.

The normally anticipated disclosures regarding the nature of operations, which are necessary to comply with IAS 1, also apply to entities engaging in biological and agricultural operations. These disclosures could incorporate, either in narrative form or as quantified terms, information about the groups of biological assets, the nature of activities regarding each of these groups, the maturity or immaturity for intended purposes of each group, the relative significance of different groups by reference to non-monetary amounts (e.g., numbers of animals, acres of trees) dedicated to each, and non-financial measures or estimates of the physical quantities of each group of assets at the date of the statement of financial position and the output of agricultural produce during the reporting period.

Good practice, necessary to make the financial statements meaningful for users, would dictate that disclosures be made of:

1. The measurement bases used to derive fair values;
2. Whether an independent appraiser was utilized;
3. Where relevant, the discount rate employed to compute net present values, along with the number of years' future cash flows assumed;
4. Additional details about the changes in fair value from the prior period, where needed;
5. Any restrictions on title and any pledging of biological assets as security for liabilities;
6. Commitments for further development or acquisitions of biological assets;
7. Specifics about risk management strategies employed by the entity (note that the use of hedging is widespread. The futures market, now heavily employed to control financial risks, was developed originally for agricultural commodities); and
8. Activities which are unsustainable, along with estimated dates of cessation of those activities.

Other possible disclosures include the carrying amount of agricultural land (at either historical cost or revalued amount) and of agricultural produce (governed by IAS 2, and subject to separate classification in the statement of financial position).

## EXAMPLES OF FINANCIAL STATEMENT DISCLOSURES

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### Sappi 2011 Integrated Report At September 2012

#### 2.3 Critical accounting policies and estimates

##### 2.3.5 Plantations

Plantations are stated at fair value less estimated cost to sell at the harvesting stage.

In arriving at plantation fair values, the key assumptions are estimated prices less cost of delivery, discount rates, and volume and growth estimations. All changes in fair value are recognized in the period in which they arise.

The impact of changes in estimate prices, discount rates, and volume and growth assumptions may have on the calculated fair value and other key financial information on plantations is disclosed in note 10.

- **Estimated prices less cost of deliver**

The group uses a 12 quarter rolling historical average price to estimate the fair value of all immature timber and mature timber that is to be felled in more than 12 months from the reporting date. Twelve quarters is considered a reasonable period of time after taking the length of the growth cycle of the plantations into account. Expected future price trends and recent market transactions involving comparable plantations are also considered in estimating fair value.

Mature timber that is expected to be felled within 12 months from the end of the reporting period are valued using unadjusted current market prices. Such timber is expected to be used in the short-term and consequently, current market prices are considered an appropriate reflection of fair value.

The fair value is derived by using the prices as explained above reduced by the estimated cost of delivery. Cost of delivery includes all costs associated with getting the harvested agricultural produce to the market, including harvesting, loading, transport and allocated fixed overheads.

- **Discount rate**

The discount rate used is the applicable pre-tax weighted-average cost of capital of the business unit.

- **Volume and growth estimations and cost assumptions**

The group focuses on good husbandry techniques which include ensuring that the rotation of plantations is met with adequate planting activities for future harvesting. The age threshold use for quantifying immature timber is dependent on the rotation period of the specific timber genus which varies between 8 and 18 years. In the Southern African region, softwood less than eight years and hardwood less than five years are classified as immature timber.

Trees are generally felled at the optimum age when ready for intended use. At the time the tree is felled it is taken out of plantations and accounted for under inventory and reported as depletion cost (fellings).

Depletion costs include the fair value of timber felled, which is determined on the average method, plus amounts written off against standing timber to cover loss or damage caused by fire, disease and stunted growth. These costs are accounted for on a cost per metric ton allocation method multiplied by unadjusted current market prices. Tons are calculated using the projected growth to rotation age and are extrapolated to current age on a straight-line basis.

The group has projected growth estimation over a period of 8 to 18 years per rotation. In deriving this estimate, the group established a long-term sample plot network which is representative of the species and sites on which trees are grown and the measured data from these permanent sample plots were used as input into the group's growth estimation. Periodic adjustments are made to existing models for new genetic material.

The group directly manages plantations established on land that is either owned or leased from third parties. Indirectly managed plantations represent plantations established on land held by independent commercial farmers where Sappi provides technical advice on the growing and tendering of trees. The associated costs for managing the plantations are recognized as silviculture costs in cost of sales (see note 4).

<b>10. Plantations</b>	<b>2012</b>	<b>2011</b>
<b>US\$ million</b>		
<b>Plantations</b>		
Fair value of plantations at beginning of year	<b>580</b>	<b>687</b>
Gains arising from growth	<b>83</b>	<b>81</b>
Fire, hazardous weather and other damages	<b>(4)</b>	-
(Loss) gain arising from fair value price changes	<b>(15)</b>	<b>(16)</b>
Harvesting—agriculture produce (fellings)	<b>(73)</b>	<b>(82)</b>
Disposals	<b>(1)</b>	
Translation difference	<b>(15)</b>	<b>(90)</b>
Fair value of plantations at end of year	<b>555</b>	<b>580</b>

Sappi manages the establishment, maintenance and harvesting of its plantations on a compartmentalized basis. These plantations are comprised of pulpwood and saw logs and are managed in such a way so as to ensure that the optimum fiber balance is supplied to its paper and pulping operations in Southern Africa.

As the group manages its plantations on a rotational basis, the respective increases by means of growth are negated by depletions over the rotation period for the group's own production or sales.

The group owns plantations on land that we own, as well as on land that we lease. The group discloses both of these as directly managed plantations. With regard to indirectly managed plantations, the group has several different types of agreements with many independent farmers. The terms of the agreements depend on the type and specific needs of the farmer and the areas planted ranging in duration from one to more than 20 years. In certain circumstances, we provide loans to farmers that are disclosed as accounts receivable on the group balance sheets (these loans are considered, individually and in aggregate, immaterial to the group). If the group provides seedlings, silviculture and/or technical assistance, the costs are expensed when incurred by the group.

The group is exposed to financial risks arising from climatic changes, disease and other natural risks such as fire, flooding and storms and human-induced losses arising from strikes, civil commotion and malicious damage. These risks are covered by an appropriate level of insurance as determined by management. The plantations have an integrated management system that complies with FSC standards.

Changes in estimate prices, the discount rate, costs to sell and volume and growth assumptions applied in the valuation of immature timber may impact the calculated fair value as tabled below:

US\$million	2012	2011	2010
<b>Market price changes</b>			
1% increase in market prices	4	4	2
1% decrease in market prices	(4)	(4)	(2)
<b>Discount rate (for immature timber)</b>			
1% increase in market rate	(4)	(4)	(5)
1% decrease in market rate	4	4	5
<b>Volume assumption</b>			
1% increase in estimate of volume	5	6	9
1% decrease in estimate of volume	(5)	(6)	(9)
<b>Costs to sell</b>			
1% increase in costs to sell	(3)	(3)	(1)
1% decrease in costs to sell	3	3	1
<b>Growth assumption</b>			
1% increase in rate of growth	2	1	2
1% decrease in rate of growth	(2)	(1)	(2)

## OTHER ISSUES

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### Agricultural Land

Agricultural land is not deemed a biological asset; thus, the principles espoused in IAS 41 for biological and agricultural assets do not apply to land. The requirements of IAS 16, which are applicable to other categories of property, plant and equipment, apply equally to agricultural land. The use of the allowed alternative method (i.e., revaluation), particularly for land-based systems such as orchards, plantations and forests, where the fair value of the biological asset was determined from net realizable values which included the underlying land, would be logical and advisable, but is not actually a requirement. It would also enhance the usefulness of the financial statements if land held by entities engaged in agricultural activities is further classified in the statement of financial position according to specific uses. Alternatively, this information can be conveyed in the notes to the financial statements.

### Bearer Plants

On June 30, 2014 the IASB published amendments (effective for periods beginning on or after January 1, 2016) that change the financial reporting for bearer plants, such as grapes vines, rubber trees and oil palms. The IASB has declared that the accounting for bearer plants falls within the scope of IAS 16, *Property, Plant, and Equipment* (see Chapter 9) because their operation is similar to that of manufacturing. Although bearer plants are included within the scope of IAS 16, the produce on bearer plants will remain within the scope of IAS 41.

Bearer plants are defined as a class of biological assets that, once mature, is held by an entity solely to grow produce over their productive life. At the end of their productive lives they are usually scrapped. Once a bearer plant is mature, it will bear produce, but its biological transformation in generating significant future economic benefits is not significant.

In effect bearer plants may be accounted for using either a cost model or a revaluation model could be used for bearer plants, whilst the produce growing on the bearer plants would still be accounted for using the fair value model.

### **Intangible Assets Related to Agriculture**

Under IAS 38, intangible assets may be carried at cost or at revalued amounts, but only to the extent that active markets exist for the intangibles. In general, it is not expected that such markets will exist for commonly encountered classes of intangible assets. On the other hand, agricultural activities are expected to frequently involve intangibles such as water rights, production quotas and pollution rights, and it is anticipated that for these intangibles active markets may exist.

To enhance the internal consistency of financial statements of entities engaged in biological and agriculture operations, if intangibles which pertain to the entity's agricultural activities have active markets, these should be presented in the statement of financial position at their fair values. This is not, however, an actual requirement.

### **Government Grants**

IAS 20 addresses the accounting for government grants, whether received with conditions attached or not, and whether received in cash or otherwise. As noted above, IAS 41 effectively amends this in the case of reporting by entities receiving an unconditional government grant related to a biological asset that is measured at its fair value less estimated costs to sell. Such grants are only recognized in the income statement when the grant becomes receivable. For grants which are conditional, recognition in income will occur when there is reasonable assurance that the conditions have been met. If conditional grants are received before the conditions have been met, the grant should be recognized as a liability, not as revenue. For grants received in the form of non-monetary assets, fair value is to be assessed in order to account for the grant.

## **US GAAP COMPARISON**

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US GAAP provides specific incremental guidance for the accounting, reporting and disclosure of agricultural activities. Agricultural products and activities include animals (livestock) and plants. However, ASC 905 does not apply to growers of timber, sugarcane and pineapple in tropical regions, breeding animals in competitive sports, or merchants or non-cooperative processors of agricultural products that purchase commodities from growers, contract harvesters, or others serving agricultural producers.

The carrying amount of agricultural products is historical cost. For assets deemed property, plant and equipment, depreciation is systematic and rational based on its utility. Permanent improvements to land, such as grading, are not depreciated because their utility does not diminish with time. Short-lived animals, such as chickens, are classified as inventory. The costs of reclaiming productive capacity from the land that relates specifically to the current year harvest are accrued as part of the costs, even though these costs will benefit subsequent years' harvest. In instances where additional costs are required after harvest of a

particular crop to overcome a physical or noxious condition, those costs are estimated and accrued as costs of the harvested crop. Costs involved in raising progeny to a productive state (i.e., a calf to the point it produces milk) are accumulated as part of the costs and depreciated when the livestock reaches maturity.

Market prices for valuing crops or livestock are only used in valuing inventory or PP&E in exceptional circumstances when it is not practicable to determine an appropriate cost basis for products. Per ASC 905-330-30-1, a market basis is acceptable if the products meet all of the following criteria: (1) The products have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) The products have characteristics of unit interchangeability, (3) The products have relatively insignificant costs of disposal.

US GAAP also provides guidance for Agricultural Cooperatives. An agricultural cooperative is an organization which performs any of following on behalf of its patrons: sale, processing, marketing and other activities. Cooperatives can provide services for non-patrons, but the results and financial positions must be separately presented. Cooperatives generally distribute all profits to patrons, except for retains, which are reserves to insulate the cooperative from financial shocks. Revenue is recorded by patrons whenever title passes to the cooperative. If title does not pass, the revenue is accounted for on a consignment basis, with revenue deferred until sale to the third-party buyer takes place. The equity section of an agricultural cooperative must separate earnings and balance between patrons and non-patrons. This is because the cooperative's mission is to perform service on behalf of the patrons, and each patron may have different rights and obligations, although bylaws or other agreements generally govern most of the activities. Frequently, cooperatives pool products from patrons and remit proceeds to each patron based on the volume sold.

Investments by patrons in cooperatives are accounted for under the cost method or the equity method if it has significant influence (per applicable US GAAP). The investment balance includes retains. The investment balance is reduced if cooperative losses will likely not be recovered by the patron.

## DEFINITIONS OF TERMS

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**Exploration and evaluation assets.** Exploration and evaluation expenditures recognized as assets in accordance with the reporting entity's accounting policy.

**Exploration and evaluation expenditures.** Expenditures incurred by a reporting entity in connection with the exploration for and evaluation of mineral resources, before the technical feasibility and commercial viability of extracting a mineral resource have been demonstrated.

**Exploration for and evaluation of mineral resources.** The search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

## EXPLORATION AND EVALUATION OF MINERAL RESOURCES

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### Background

In mid-2005, the IASB issued IFRS 6, *Exploration for and Evaluation of Mineral Resources*, which proposed an interim solution, designed to facilitate compliance with IFRS by entities reporting exploration and evaluation assets, without making substantial changes to existing accounting practices. The reasons cited by the IASB for the development of an interim standard addressing exploration for and evaluation of mineral resources were as follows:

1. There were no extant IFRS that specifically addressed the exploration for and evaluation of mineral resources, which had been excluded from the scope of IAS 38. Furthermore, mineral rights and mineral resources such as oil, natural gas and similar non-regenerative resources were excluded from the scope of IAS 16. Accordingly, a reporting entity having such assets and activities is required to determine accounting policies for such expenditures in accordance with IAS 8.
2. There were alternative views on how the exploration for and evaluation of mineral resources and, particularly, the recognition of exploration and evaluation assets, were required to be accounted for under IFRS.
3. Accounting practices for exploration and evaluation expenditures under various national GAAP standards were quite diverse, and often differed from practices in other sectors for items that could have been considered similar (e.g., the accounting practices for research costs under IAS 38).
4. Exploration and evaluation expenditures represented a significant cost to entities engaged in extractive activities.
5. While relatively few entities incurring exploration and evaluation expenditures were reporting under IFRS at the time (circa 2005), many more were expected to do so, particularly given the EU mandate for publicly listed entities to report consolidated results in conformity with IFRS, which became effective in 2005, as well as the rapidly growing worldwide acceptance of IFRS.

### IFRS 6 in Greater Detail

IFRS 6 sets forth a set of generalized principles that define the main issues for reporting entities that have activities involving the exploration for and evaluation of mineral resources. These principles are as follows:



1. IFRS fully applies to these entities, except when they are specifically excluded from the scope of a given standard.
2. Reporting entities may continue employing their existing accounting policies to account for exploration and evaluation assets, but any change in accounting will have to qualify under the criteria set forth by IAS 8.
3. A reporting entity that recognizes exploration and evaluation assets must assess those assets for impairment annually, in accordance with IAS 36. However, the entity may conduct the assessment at the level of “a cash-generating unit for exploration and evaluation assets,” rather than at the level otherwise required by IAS 36. As set forth by IFRS 6, this is a higher level of aggregation than would have been the case under a strict application of the criteria in IAS 36.

Thus, according to IFRS 6, entities that have assets used for exploration and evaluation of mineral resources are to report under IFRS, but certain assets may be subject to alternative measurement requirements. The adoption of new, specialized requirements will be optional, at least at this time. The next phase of the extractive industries project may result in new requirements.

#### ***Cash-generating units for exploration and evaluation assets***

The most significant aspect of IFRS 6 concerns its establishment of a unique definition of *cash-generating units* for impairment testing. It created a different level of aggregation for mineral exploration and evaluation assets, when compared to all other assets subject to impairment considerations under IAS 36. The reason for this distinction is that the IASB was concerned that requiring entities to use the standard definition of a cash-generating unit, as set forth by IAS 36, when assessing exploration and evaluation assets for impairment might have negated the effects of the other aspects of the proposal, thereby resulting in the inappropriate recognition of impairment losses under certain circumstances. Specifically, the IASB was of the opinion that the standard definition of a cash-generating unit could cause there to be uncertainty about whether the reporting entity's existing accounting policies were consistent with IFRS, because exploration and evaluation assets would often not be expected to:

1. Be the subject of future cash inflow and outflow projections relating to the development of the project, on a reasonable and consistent basis, without being heavily discounted because of uncertainty and lead times;
2. Have a determinable net selling price; or
3. Be readily identifiable with other assets that generate cash inflows as a specific cash-generating unit.

In the IASB's view, the implications of the foregoing matters were that an exploration and evaluation asset would often be deemed to be impaired, inappropriately, if the IAS 36 definition of a cash-generating unit was applied without at least the potential for modification.

Given the foregoing concern, in the draft standard the IASB had proposed a unique definition of a cash-generating unit for exploration and evaluation assets. The cash-generating unit for exploration and evaluation assets was to be the cash-generating unit that represents the smallest identifiable group of assets that, together with exploration and evaluation assets, generates cash inflows from continuing use to which impairment tests were

applied by the entity under the accounting policies applied for its most recent annual financial statements. The entity would be permitted to elect, under the proposed rules, to apply either the IAS 36 definition of a cash-generating unit, or the special definition above. The election would have to be made when the proposed IFRS was first applied. Beyond the choice of definition of the cash-generating unit, the mechanics of the impairment test itself would be as set forth at IAS 36.

During the development of IFRS 6, the IASB expressed concern that the availability of a choice in defining cash-generating units might impair the reliability and relevance of financial statements. To limit this risk, it proposed that a cash-generating unit for exploration and evaluation assets could be no larger than a segment, as defined by then-extant standard IAS 14.

As adopted, IFRS 6 mandates the proposed approach to impairment testing. Specifically, the standard provides that the reporting entity is to determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing those assets for impairment as that need arises. Accordingly, each cash-generating unit or group of units to which an exploration and evaluation asset is allocated is not to be larger than an operating segment, determined in accordance with IFRS 8 (see discussion of IFRS 8 in Chapter 28). The level identified by the entity for the purposes of testing exploration and evaluation assets for impairment can comprise one or more cash-generating units.

IFRS 6 provides that exploration and evaluation assets are to be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset might exceed the recoverable amount, as with other impairment testing prescribed by IAS 36. When facts and circumstances indicate that the carrying amount might exceed the respective recoverable amount, the reporting entity is required to measure, present and disclose any resulting impairment loss in accordance with IAS 36, with the exception that the extent of aggregation may be greater than for other assets.

In addition to the criteria set forth in IAS 36, IFRS 6 identifies certain indications that impairment may have occurred regarding the exploration and evaluation assets. It states that one or more of the following facts and circumstances indicate that the reporting entity should test exploration and evaluation assets for impairment:

1. The period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.
2. Substantive expenditure by the entity on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.
3. Exploration for and evaluation of mineral resources in the specific area have not resulted in the discovery of commercially viable quantities of mineral resources, and accordingly the reporting entity decided to discontinue such activities in the specific area.
4. Sufficient data exist to suggest that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

If testing identifies impairment, the consequent adjustment of carrying amounts to the lower, impaired value results in a charge to current operating results, just as described by IAS 36 (discussed in Chapter 9).

### Assets Subject to IFRS 6 Categorization

IFRS 6 provides a listing of assets that would fall within the definition of exploration and evaluation expenditures. These assets are those that are related to the following activities:

1. Acquisition of rights to explore;
2. Topographical, geological, geochemical and geophysical studies;
3. Exploratory drilling;
4. Trenching;
5. Sampling; and
6. Activities in relation to evaluating technical feasibility and commercial viability of extracting a mineral resource.

The qualifying expenditures notably *exclude* those that are incurred in connection with the development of a mineral resource once technical feasibility and commercial viability of extracting a mineral resource have been established. Additionally, any administration and other general overhead costs are explicitly excluded from the definition of qualifying expenditures.

### *Availability of cost or revaluation models*

Consistent with IAS 16, IFRS 6 requires initial recognition of exploration and evaluation assets based on actual cost, but subsequent recognition can be effected under either the historical cost model or the revaluation model. The standard does not offer guidance regarding accounting procedures, but it is presumed that those set forth under IAS 16 would be applied (e.g., regarding recognition of impairment and recoveries of previously recognized impairments). (See discussion in Chapter 9.)

### *Financial statement classification*

IFRS 6 provides that the reporting entity is to classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired, and apply the classification consistently. It notes that certain exploration and evaluation assets, such as drilling rights, have traditionally been considered intangible assets, while other assets have historically been identified as tangible (such as vehicles and drilling rigs). The standard states that, to the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption (that would otherwise be reported as depreciation) becomes part of the cost of the intangible asset. Using a tangible asset to develop an intangible asset, however, does not warrant classifying the tangible asset as an intangible asset.

In the statement of financial position, exploration and evaluation assets are to be set forth as a separate class of long-lived assets.

IFRS 6 only addresses exploration and evaluation. It holds that once the technical feasibility and commercial viability of extracting a mineral resource has been demonstrated, exploration and evaluation assets are no longer to be classified as such. At that point, the exploration and evaluation assets are to be assessed for impairment, and any impairment loss recognized, before reclassification of any remainder as operating or other asset classes.

### *Disclosure requirements under IFRS 6*

A reporting entity is required to disclose information that identifies and explains the amounts recognized in its financial statements that pertain to the exploration for and evaluation of mineral resources. This could be accomplished by disclosing:

1. Its accounting policies for exploration and evaluation expenditures, including the recognition of exploration and evaluation assets.
2. The amounts of assets, liabilities, income and expense (and, if a statement of cash flows using the direct method is presented, cash flows) arising from the exploration for and evaluation of mineral resources.

The Exposure Draft preceding IFRS 6 had proposed that the mandatory disclosures identify the level at which the entity assesses exploration and evaluation assets for impairment. While this is not set forth in IFRS 6, it is obviously a good practice, and is therefore strongly recommended by the authors.

## **EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES**

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Since IFRS 6 is only an interim standard that does not deal with all aspects of the recognition and measurement of mining assets and liabilities it is important to illustrate how the recognition and measurement of mining assets are applied through a practical example.

### **Anglo American 2014 Annual Report**

#### **1. Accounting policy: Exploration, evaluation and development expenditure**

Exploration and evaluation expenditure is expensed in the year in which it is incurred. When a decision is taken that a mining property is economically feasible, all subsequent evaluation expenditure is capitalized within property, plant and equipment including, where applicable, directly attributable pre-production development expenditure. Capitalization of such expenditure ceases when the mining property is capable of commercial production.

Exploration properties acquired are recognized in the balance sheet at cost less any accumulated impairment losses. Such properties and capitalized evaluation and pre-production development expenditure prior to commercial production are assessed for impairment in accordance with the Group's accounting policy stated above.

#### **2. Critical accounting judgements and key sources of estimation uncertainty**

In the course of preparing financial statements, management necessarily makes judgements and estimates that can have a significant impact on the financial statements. The most critical of these relate to estimation of Ore Reserves, assessment of fair value, impairment of assets, restoration, rehabilitation and environmental costs, deferred stripping, taxation, retirement benefits, contingent liabilities and joint arrangements. The use of inaccurate assumptions in assessments made for any of these estimates could result in a significant impact on financial results.

##### **Ore reserve estimates**

When determining Ore Reserves, which may be used to calculate depreciation on the Group's mining properties, assumptions that were valid at the time of estimation may change when new information becomes available. Any changes could affect prospective depreciation rates and asset carrying values.

The calculation of the unit of production rate of amortization could be impacted to the extent that actual production in the future is different from current forecast production based on Proved and Probable Ore Reserves.

Factors which could impact useful economic lives of assets and Ore Reserve estimates include:

- Changes to Proved and Probable Ore Reserves
- The grade of Ore Reserves varying significantly from time to time
- Differences between actual commodity prices and commodity price assumptions used in the estimation of Ore Reserves
- Renewal of mining licences
- Unforeseen operational issues at mine sites
- Adverse changes in capital, operating, mining, processing and reclamation costs, discount rates and foreign exchange rates used to determine Ore Reserves.

### **IFRIC 20, *Stripping Costs in the Production Phase of a Surface Mine***

In August 2011, the IASB published IFRIC 20, *Stripping Costs in the Production Phase of a Surface Mine*.

This IFRIC addresses the following three questions:

1. How and what production stripping costs to recognize as an asset;
2. How to initially measure the stripping activity asset; and
3. How to subsequently measure the stripping activity asset.

In summary, the IFRIC concludes that:

- When benefits from the stripping activity are realized in the form of inventory produced, the principles of IAS 2, *Inventories* shall be applied. However, to the extent that the benefit is the improved access to ore, the entity shall recognize these costs as a non-current asset. This non-current asset will be known as the “stripping activity asset.”
- The stripping activity asset will be accounted for as part of an existing asset (an enhancement of an existing asset) and will be classified as either tangible or intangible according to the nature of the existing asset of which it forms a part.
- The stripping activity asset will be initially measured at cost.
- The stripping activity asset will be subsequently measured at cost or revalued amount less depreciation or amortization and less impairment losses, in the same way as the existing asset of which it is a part.
- The stripping activity asset will be depreciated or amortized on a systematic basis, over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity.

This IFRIC becomes effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted.

The Interpretation applies to production stripping costs incurred on or after the beginning of the earliest period presented. Any “predecessor stripping asset” at that date is required to be reclassified as a part of the existing asset to which the stripping activity is related (to the extent there remains an identifiable component of the ore body to which it can be associated), or otherwise recognized in opening retained earnings at the beginning of the earliest period presented.

The following practical example of an accounting policy and illustrate how deferred stripping is applied in practice.

## EXAMPLE OF FINANCIAL STATEMENT DISCLOSURES

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### Anglo American 2014 Annual Report

#### 1. Accounting policies: Deferred stripping

The removal of overburden and other mine waste materials is often necessary during the initial development of a mine site, in order to access the mineral ore deposit. The directly attributable cost of this activity is capitalized in full within mining properties and leases, until the point at which the mine is considered to be capable of commercial production. This is classified as expansionary capital expenditure, within investing cash flows.

The removal of waste material after the point at which a mine is capable of commercial production is referred to as production stripping.

When the waste removal activity improves access to ore extracted in the current period, the costs of production stripping are charged to the income statement as operating costs in accordance with the principles of IAS 2 *Inventories*.

Where production stripping activity both produces inventory and improves access to ore in future periods the associated costs of waste removal are allocated between the two elements. The portion which benefits future ore extraction is capitalized within stripping and development capital expenditure. If the amount to be capitalized cannot be specifically identified it is determined based on the volume of waste extracted compared with expected volume for the identified component of the orebody. Components are specific volumes of a mine's orebody that are determined by reference to the Life of Mine Plan.

In certain instances significant levels of waste removal may occur during the production phase with little or no associated production. This may occur at both open pit and underground mines, for example longwall development. The cost of this waste removal is capitalized in full.

All amounts capitalized in respect of waste removal are depreciated using the unit of production method based on Proved and Probable Ore Reserves of the component of the orebody to which they relate.

The effects of changes to the Life of Mine Plan on the expected cost of waste removal or remaining reserves for a component are accounted for prospectively as a change in estimate.

#### 2. Critical accounting judgements and key sources of estimation uncertainty: Deferred stripping

The Group defers stripping costs onto the balance sheet where they are considered to improve access to ore in future periods. Where the amount to be capitalized cannot be specifically identified it is determined based on the volume of waste extracted compared with expected volume for the identified component of the orebody. This determination is dependent on an individual mine's pit design and Life of Mine Plan and therefore changes to the pit design or Life of Mine Plan will result in changes to these estimates. Identification of the components of a mine's orebody is made by reference to the Life of Mine Plan. The assessment depends on a range of factors including each mine's specific operational features and materiality

## FUTURE DEVELOPMENTS

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### Extractive Industry Discussion Paper

In April 2010, the IASB published the discussion paper, *Extractive Activities*. Where relevant, the IASB Issues Paper and comments received in response were considered by the project team in developing this Discussion Paper. The Discussion Paper does not represent

the views of the IASB, but rather those of the project team. After considering the responses received on the Discussion Paper, the IASB decided to pause the project and moved extractive activities to an exploratory phase they are not currently working on.

The Discussion Paper addresses the following four questions:

1. How to estimate and classify the quantities of minerals or oil and gas discovered;
2. How to account for minerals or oil and gas properties;
3. How minerals or oil and gas properties should be measured; and
4. What information about extractive activities should be disclosed.

In summary, the Paper proposes to:

- Introduce mineral reserve and resource definitions based on industry practice.
- Eliminate “phase accounting”—separate accounting for exploration and evaluation, development, production and so on—in favour of one asset, either a “mineral asset” or “oil and gas asset.”
- Account for mining and oil and gas projects using a “unit of account” which is effectively the “area of interest” accounting commonly used in Australia under current standards.
- Require measurement based on historical cost, but countenancing the possibility of using another measure such as current value or (more likely) fair value.
- Retain a modified impairment approach to assets in the exploration and evaluation stage.
- Introduce extensive disclosures, including a form of “standardized value for reserves” resources and possibly responding to the “publish what you pay” lobby.

## US GAAP COMPARISON

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US GAAP separately addresses extractive industries, specifically for mining and oil and gas-producing companies, accounting for the acquisition of property, exploration, development, production, and support equipment and facilities.

US GAAP provides specific guidance regarding the presentation of costs and revenues, capitalization, depreciation, derecognition and disclosure of costs related to oil and gas extraction. However, extracted resources are valued at cost with very few exceptions.

Disclosures for oil and gas activities are substantial and required specialized engineering estimates. Some of these disclosures are:

- Proved oil and gas reserve quantities;
- Capitalized costs relating to oil- and gas-producing activities;
- Continued capitalization of exploratory well costs;
- Costs incurred for property acquisition, exploration and development;
- Results of operations of oil- and gas-producing activities;
- A standardized measure of discounted future net cash flows related to proved oil and gas reserve quantities.

There are additional disclosures for public companies. Disclosures also include net quantities for equity-accounted entities. The unit of account for impairments is specifically at the field level. Additionally, if a field is proved non-productive after the balance sheet date, but before the financial statements are available for issue, it should be considered for an

adjusting subsequent event, not merely a disclosure as is required for other impairments related to conditions occurring after the reporting date.

Under US GAAP all costs related to oil- and gas-producing activities are accounted for under either the successful efforts method or the full cost method, and the type of exploration and evaluation (E&E) costs capitalized under each method differs. For other extractive industries, E&E costs are generally expensed as they are incurred unless an identifiable asset is created by the activity.

Additionally oil- and gas-producing entities do not segregate capitalized E&E costs into tangible and intangible components; instead all capitalized costs are classified as tangible assets. Furthermore the test for recoverability is usually conducted at the oil and gas field level under the successful efforts method, or by geographic region under the full cost method.



**Fair value.** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction.

**Financial guarantee contract.** A contract that requires 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 in accordance with the original or modified terms of a debt instrument.

**Financial risk.** The risk of a possible future change in one or more of 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 the variable is not specific to a party to the contract.

**Guaranteed benefits.** Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

**Guaranteed element.** An obligation to pay guaranteed benefits, included in a contract that contains a discretionary participation feature.

**Insurance asset.** An insurer's net contractual rights under an insurance contract.

**Insurance contract.** A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

**Insurance liability.** An insurer's net contractual obligations under an insurance contract.

**Insurance risk.** Risk, other than financial risk, transferred from the holder of a contract to the issuer.

**Insured event.** An uncertain future event that is covered by an insurance contract and creates insurance risk.

**Insurer.** The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.

**Liability adequacy test.** An assessment of whether the carrying amount of an insurance liability needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.

**Policyholder.** A party that has a right to compensation under an insurance contract if an insured event occurs.

**Reinsurance assets.** A cedant's net contractual rights under a reinsurance contract.

**Reinsurance contract.** An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.

**Reinsurer.** The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.

**Unbundle.** Account for the components of a contract as if they were separate contracts.

## INSURANCE CONTRACTS

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An insurance contract is an arrangement under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable—which would continue to be accounted for under IAS 39 as derivative contracts). A contract

creates sufficient insurance risk to qualify as an insurance contract only if there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether there is a reasonable possibility of such significant change, it is necessary to consider the probability of the event and the magnitude of its effect. Also, a contract that qualifies as an insurance contract at inception or later remains an insurance contract until all rights and obligations are extinguished or expire. If a contract did not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if, and only if, a significant change in the present value of the insurer's net cash flows becomes a reasonable possibility.

A range of other arrangements, which share certain characteristics with insurance contracts, would be excluded from any imposed insurance contracts accounting standard, since they are dealt with under other standards. These include financial guarantees (including credit insurance) measured at fair value; product warranties issued directly by a manufacturer, dealer or retailer; employers' assets and liabilities under employee benefit plans (including equity compensation plans); retirement benefit obligations reported by defined benefit retirement plans; contingent consideration payable or receivable in a business combination; and contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, certain license fees, royalties, lease payments and similar items).

IFRS 4 applies to all insurance contracts, including reinsurance. Thus, the standard does not relate only to insurance companies, strictly defined. Insurance assets and liabilities are subject to recognition when contractual rights and obligations, respectively, are created under the terms of the contract. When these no longer exist, derecognition will take place.

IFRS 4 does not apply to product warranties issued directly by a manufacturer, dealer or retailer; employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; contractual rights or obligations that are contingent on the future use of or right to use a non-financial item, as well as lessee's residual value guarantees on finance leases; financial guarantees entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39; contingent consideration payable or receivable in a business combination; or direct insurance contracts that an entity holds as a policyholder.

### ***Insurance risk***

IFRS 4 sets forth the accounting and financial reporting requirements which are applicable to all insurance contracts (including reinsurance contracts) that are issued by the reporting entity, and to reinsurance contracts that the reporting entity holds, except for specified contracts which are covered by other standards. IFRS 4 does not apply to other assets and liabilities of an insurer (e.g., financial assets and financial liabilities which are addressed by IAS 39), nor does it address accounting or financial reporting by policyholders. The standard uses the term "insurer" to denote the party accepting liability as an insurer, whether or not the entity is legally or statutorily an insurance company.

IFRS 4 replaces what had been an indirect definition of an insurance contract under IAS 32 with a positive definition based on the transfer of significant insurance risk from the policyholder to the insurer. This definition covers most motor, travel, life, annuity, medical, property, reinsurance and professional indemnity contracts. Some catastrophe bonds and weather derivatives would also qualify, as long as payments are linked to a specific climatic

or other insured future event that would adversely affect the policyholder. On the other hand, policies that transfer no significant insurance risk—such as some savings and pensions plans—will be deemed financial instruments, addressed by IAS 39, regardless of their legal form. IAS 39 also applies to contracts that principally transfer financial risk, such as credit derivatives and some forms of financial reinsurance.

There may be some difficulty in classifying the more complex products (including certain hybrids). To facilitate this process, the IASB has explained that insurance risk will be deemed *significant* only if an insured event could cause an insurer to pay significant additional benefits in *any* scenario, apart from a scenario that lacks commercial substance (which in the Exposure Draft preceding IFRS 4 was denoted as a “plausible” event). As a practical matter, reporting entities should compare the cash flows from (1) the occurrence of the insured event against (2) all other events. If the cash flows under the former are significantly larger than under the latter, significant insurance risk is present.

For example, when the insurance benefits payable upon death are significantly larger than the benefits payable upon surrender or maturity, there is significant insurance risk. The significance of the additional benefits is to be measured irrespective of the probability of the insured event, if the scenario has commercial substance. Reporting entities have to develop internal quantitative guidance to ensure the definition is applied consistently throughout the entity. To qualify as significant, the insurance risk also needs to reflect a *pre-existing* risk for the policyholder, rather than having arisen from the terms of the contract.

This requirement would specifically exclude from the cash flow comparison features such as waivers of early redemption penalties within investment plans or mortgages in the event of death. Since it is the contract itself that brought the charges into place, the waiver does not represent an additional benefit received for the transfer of a pre-existing insurance risk.

The application of this IFRS 4 definition may result in the redesignation of a significant fraction of existing insurance contracts as investment contracts. In other situations, the impact could be the opposite. For example, a requirement to pay benefits earlier if an insured event occurs could make a contract insurance; this means that many pure endowment contracts are likely to meet the definition of insurance. All told, insuring entities will need to set clear, consistent and justifiable contract classification criteria and rigorously apply these.

## RECOGNITION AND MEASUREMENT GUIDANCE

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### *Adequacy of insurance liabilities*

IFRS 4 imposes a *liability adequacy test*, which requires that at each reporting date the “insurer” must assess whether its recognized insurance liabilities are adequate, using then-current estimates of future cash flows under the outstanding insurance contracts. If as a result of that assessment it is determined that the carrying amount of insurance liabilities (less related deferred acquisition costs and related intangible assets, if appropriate—see discussion below) is insufficient given the estimated future cash flows, the full amount of such deficiency must be reported currently in earnings.

The standard defines minimum requirements for the adequacy test that is to be applied to the liability account. These minimum requirements are that:

1. The test considers the current estimates of all contractual cash flows, and of such related cash flows as claims handling costs, as well as cash flows that will result from embedded options and guarantees.

2. If the test shows that the liability is inadequate, the entire deficiency is recognized in profit or loss.

In situations where the insuring entity's accounting policies do not require a liability adequacy test, or provides for a test that does not meet the minimum requirements noted above, then the entity is required under IFRS 4 to:

1. Determine the carrying amount of the relevant insurance liabilities, less the carrying amount of:
  - a. Any related deferred acquisition costs; and
  - b. Any related intangible assets, such as those acquired in a business combination or portfolio transfer.
2. Determine whether the carrying amount of the relevant net insurance liabilities is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37.

The IAS 37-based amount is the required minimum liability to be presented. Therefore, if the current carrying amount is less, the insuring entity must recognize the entire shortfall in current period earnings. The corresponding credit to this loss recognition will either decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities, or both, dependent upon the facts and circumstances.

In applying the foregoing procedures, any related reinsurance assets are not considered, because an insuring entity accounts for these separately, as noted later in this discussion.

If an insuring entity's liability adequacy test meets the minimum requirements set forth above, this test is applied at the level of aggregation specified above. On the other hand, if the liability adequacy test does not meet the stipulated minimum requirements, the comparison must instead be made at the level of a portfolio of contracts that are subject to broadly similar risks and which are managed together as a single portfolio.

For purposes of comparing the recorded liability to the amount required under IAS 37, it is acceptable to reflect future investment margins only if the carrying amount of the liability also reflects those same margins. Future investment margins are defined under IFRS 4 as being employed if the discount rate used reflects the estimated return on the insuring entity's assets, or if the returns on those assets are projected at an estimated rate of return, and discounted at a different rate, with the result included in the measurement of the liability. There is a rebuttable presumption that future investment margins should not be used, however, although exceptions (see below) can exist.

#### ***Impairment testing of reinsurance assets***

When an insuring entity obtains reinsurance (making it the *cedant*), an asset is created in its financial statements. As with other assets, the reporting entity must consider whether an impairment has occurred as of the reporting date. Under IFRS 4, a reinsurance asset is impaired only when there is objective evidence that the cedant may not receive all amounts due to it under the terms of the contract, as a consequence of an event that occurred after initial recognition of the reinsurance asset, and furthermore, the impact of that event is reliably measurable in terms of the amounts that the cedant will receive from the reinsurer.

When the reinsurance asset is found to be impaired, the carrying amount is adjusted downward and a loss is recognized in current period earnings for the full amount.

### *Selection of accounting principles*

IFRS requires certain accounting practices to be adopted with regard to insurance contracts, but also allows other, existing procedures to remain in place under defined conditions. An insuring entity may, under provisions of IFRS 4, change accounting policies for insurance contracts only if such change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. Relevance and reliability are to be assessed by applying the criteria set forth in IAS 8.

To justify changing its accounting policies for insurance contracts, an insuring entity must demonstrate that the change brings its financial statements nearer to satisfying the criteria of IAS 8, but the change does not necessarily have to achieve full compliance with those criteria. The standard addresses changes in accounting policies in the context of current interest rates; continuation of existing reporting practices; prudence; future investment margins; and “shadow accounting.” These are discussed in the following paragraphs.

Regarding interest rates, IFRS 4 provides that an insuring entity is permitted, although it is not required, to change its accounting policies such that it remeasures designated insurance liabilities to reflect current market interest rates, and recognizes changes in those liabilities in current period earnings. It may also adopt accounting policies that require other current estimates and assumptions for the designated liabilities. IFRS 4 permits an insuring entity to change its accounting policies for designated liabilities, without consistently applying those policies to all similar liabilities, as the requirements under IAS 8 would suggest. If the insuring entity designates liabilities for this policy choice, it must continue to apply current market interest rates consistently in all periods to all these liabilities until they are later eliminated.

An unusual feature of IFRS 4 is that it offers affected reporting entities the option to continue with their existing accounting policies. Specifically, an insuring entity is allowed to continue the following practices if in place prior to the effective date of IFRS 4:

1. Measuring insurance liabilities on an *undiscounted* basis.
2. Measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services. It is likely that the fair value at inception of those contractual rights equals the origination costs paid, unless future investment management fees and related costs are out of line with market comparables.
3. Employing non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and intangible assets, if any) of subsidiaries, except as permitted by the above-noted interest provision. If those accounting policies are not uniform, the insuring entity may change them if the change does not make the accounting policies more diverse, and also satisfies the other requirements of the standard.

The concept of *prudence*, as set forth in IFRS 4, is meant to excuse an insuring entity from a need to change its accounting policies for insurance contracts in order to eliminate excessive prudence (i.e., conservatism). However, if the insuring entity already measures its insurance contracts with sufficient prudence, it is not permitted to introduce additional prudence following adoption of IFRS 4.

The matter of *future investment margins* requires some explanation. Under IFRS 4 it is clearly preferred that the measurement of insurance contracts should not reflect future investment margins, but the standard does not require reporting entities to change accounting policies for insurance contracts to eliminate future investment margins. On the other hand, adopting a policy that would reflect this is presumed to be improper (the standard states that there is a rebuttable presumption that the financial statements would become less relevant and reliable if an accounting policy that reflects future investment margins in the measurement of insurance contracts is adopted, unless those margins affect the contractual payments). The standard offers two examples of accounting policies that reflect those margins. The first is using a discount rate that reflects the estimated return on the insurer's assets, while the second is projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability.

IFRS 4 states that the insuring entity could possibly overcome this rebuttable presumption if the other components of a change in accounting policies increase the relevance and reliability of its financial statements sufficiently to outweigh the decrease in relevance and reliability caused by the inclusion of future investment margins. As an example, it cites the situation where the existing accounting policies for insurance contracts involve excessively prudent (i.e., conservative) assumptions set at inception, and a statutory discount rate not directly referenced to market conditions, and ignore some embedded options and guarantees. This entity might make its financial statements more relevant and no less reliable by switching to a comprehensive investor-oriented basis of accounting that is widely used and involves current estimates and assumptions; a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty; measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and a current market discount rate, even if that discount rate reflects the estimated return on the insuring entity's assets.

The actual ability to overcome IFRS 4's rebuttable presumption is fact dependent. Thus, in some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. In such approaches, the discount rate affects the measurement of the liability only indirectly, and the use of a less appropriate discount rate has a limited or no effect on the measurement of the liability at inception. In yet other approaches, the discount rate determines the measurement of the liability directly, and because the introduction of an asset-based discount rate has a more significant effect, it is highly unlikely that an insurer could overcome the rebuttable presumption noted above.

Finally, there is the matter of *shadow accounting*. According to IFRS 4, an insurer is permitted, but not required, to change its accounting policies so that a recognized but unrealized gain or loss on an asset affects those measurements in the same way that a realized gain or loss does. This is because, under some accounting models, realized gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (1) its insurance liabilities; (2) related deferred acquisition costs; and (3) related intangible assets. IFRS 4 provides that the related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) may be recognized in equity if, and only if, the unrealized gains or losses are recognized directly in equity.

### ***Unbundling***

Specific requirements pertain to *unbundling* of elements of insurance contracts, and dealing with embedded derivatives, options and guarantees.

Unbundling refers to the accounting for components of a contract as if they were separate contracts. Some insurance contracts consist of an insurance component and a deposit component. IFRS 4 in some cases requires the reporting entity to unbundle those components, and in other fact situations provides the entity with the option of unbundled accounting. Specifically, unbundling is *required* if both the following conditions are met:

1. The insuring entity can measure the deposit component (inclusive of any embedded surrender options) separately; *and*
2. The insuring entity's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.

On the other hand, unbundling is permitted, but not required, if the insuring entity can measure the deposit component separately but its accounting policies require it to recognize all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.

Unbundling is actually prohibited if an insuring entity cannot measure the deposit component separately.

If unbundling is applied to a contract, the insuring entity applies IFRS 4 to the insurance component of the contract, while using IAS 39 to account for the deposit component of that contract.

### ***Recognition***

IFRS 4 prohibits the recognition of a liability for any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date. Catastrophe and equalization provisions are thus prohibited, because they do not reflect loss events that have already occurred and, therefore, recognition would be inconsistent with IAS 37. Loss recognition testing is required for losses already incurred at each date of the statement of financial position, as described above. An insurance liability (or a part of an insurance liability) is to be removed from the statement of financial position only when it is extinguished (i.e., when the obligation specified in the contract is discharged or canceled, or expires).

In terms of display, offsetting of reinsurance assets against the related insurance liabilities is prohibited, as is offsetting of income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

### ***Discretionary participation features in insurance contracts***

Insurance contracts sometimes contain a discretionary participation feature, as well as a guaranteed element. (That is, some portion of the return to be accrued to policyholders is at the discretion of the insuring entity.) Under the provisions of IFRS 4, the issuer of such a contract may, but is not required to, recognize the guaranteed element separately from the discretionary participation feature. If the issuer does not recognize them separately, it must classify the entire contract as a liability. If, on the other hand, the issuer classifies them separately, it will classify the guaranteed element as a liability. If the entity recognizes the discretionary participation feature separately from the guaranteed element, the discretionary participation feature can be classified either as a liability or as a separate component of equity; the standard does not specify how the decision should be reached. In fact, the issuer may even split that feature into liability and equity components, if a consistent accounting policy is used to determine that split.

When there is a discretionary participation feature which is reported in equity, the reporting entity is permitted to recognize all premiums received as revenue, without separating any portion that relates to the equity component. Changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability are to be reported in earnings, while changes in the part of the discretionary participation feature classified as equity are to be accounted for as an allocation of earnings, similar to how minority interest is reported.

### ***Embedded derivatives***

If the contract contains an embedded derivative within the scope of IAS 39, that standard must be applied to that embedded derivative.

## **DISCLOSURE**

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Under the provisions of IFRS 4, insuring entities must disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts. This is accomplished by disclosure of accounting policies for insurance contracts and related assets, liabilities, income and expense; of recognized assets, liabilities, income and expense (and, if it presents its statement of cash flows using the direct method, cash flows) arising from insurance contracts. Additionally, if the insuring entity is a cedant, it must also disclose gains and losses recognized in profit or loss on buying reinsurance; and, if the cedant defers and amortizes gains and losses arising on buying reinsurance, the amortization for the period and the amounts remaining unamortized at the beginning and end of the period.

Disclosure is also required of the process used to determine the assumptions that have the greatest effect on the measurement of the recognized amounts described above. When practicable, quantified disclosure of those assumptions is to be presented as well. The effect of changes in assumptions used to measure insurance assets and insurance liabilities is required, reporting separately the effect of each change that has a material effect on the financial statements.

Finally, reconciliation of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs are mandated by IFRS 4.

Regarding the amount, timing and uncertainty of cash flows, the entity is required to disclose information that helps users to understand these matters as they result from insurance contracts. This is accomplished if the insuring entity discloses its objectives in managing risks arising from insurance contracts and its policies for mitigating those risks.

## **FUTURE DEVELOPMENTS**

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### **Phase II of the IASB Insurance Project**

The IASB issued a Discussion Paper in May 2007, an Exposure Draft in July 2001 and a second Exposure Draft issued in June 2013. The lengthy deliberations suggest the complexity of the issues and the controversy anticipated to follow any firm decisions the IASB will make. The proposals proposed a comprehensive measurement approach for all types of insurance contracts issued by entities (and reinsurance contracts held by entities), with some practical expedients and simplification options in certain instances.

The approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and



outflows (benefits and claims). An insurer would apply to that package of cash flows a measurement approach that uses the following building blocks:

1. A current estimate of the expected future cash flows.
2. A discount rate that adjusts those cash flows for the time value of money.
3. An explicit risk adjustment.
4. A contractual service margin.

The first three building blocks are regarded to be the fulfillment cash flows and the contractual service margin reflects the entity's obligation to provide insurance coverage. The contractual service margin is measured as the difference between the risk adjusted present value of expected outflows (the fulfillment cash flows) and outflows at the inception of the contract, which is updated for changes in future service-related estimations.

The IASB is still deliberating the project and no final date for a revised standard is proposed.

## US GAAP COMPARISON

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The US GAAP guidance on insurance contracts covers insurance activities, acquisition costs, claim costs and liabilities for future policy benefits, policyholder dividends and separate accounts. Four methods of recognition for premium revenue and contract liabilities are developed: short-duration contract accounting and three methods for long-duration contract accounting, which are traditional, universal life and participating contracts. Generally, the four methods reflect the nature of the insurance entity's obligations and policyholder rights under the provisions of the contract. Acquisition costs are amortized over the life of the policy and subject to impairment based on the adequacy of premiums for policies in light of circumstances at the balance sheet date.

Short-duration contracts, which are for a short period, usually one year, generally require revenue recognition on a straight-line basis. Long-duration contracts, in most cases, require offsetting of receivables or cash against unrecognized revenue. This revenue is recognized commensurate with the risk insured. Another feature of long-duration contract accounting is that for each reporting period, liabilities for coverage risk are assessed and increased if needed. The offset is recognized in the current period expense.

US GAAP also covers accounting for reinsurance contracts. These arrangements transfer some or all of the risk of insurance to a third party (not the insured). Generally, the accounting is similar to insurance contracts, although there are specific criteria for determining if the original insurer has transferred the risks to the reinsurer.

The concept of separate accounts specifies accounting when assets are specifically segregated for a particular policyholder, for example, variable annuity contracts that guarantee some minimum level of benefits.

The FASB issued a proposed Accounting Standards Update, *Insurance Contracts (Topic 834)* in June 2013. Redeliberations based on feedback from the exposure document are underway. The proposed Update would improve convergence of US GAAP and IFRS. The proposals contain similar fundamentals, most notably the use of current estimates, but differences exist. The proposal and a detailed comparison with the IFRS proposal is available at [ifrs.org](http://ifrs.org).

income and various tax credits may arise, the accurate determination of interim period income tax expense is often difficult. Other annual operating expenses may be concentrated in one interim period, yet benefit the entire year's operations. Examples include advertising expenses and major repairs or maintenance of equipment, which may be seasonal in nature. The effects of seasonal fluctuations and temporary market conditions further limit the reliability, comparability and predictive value of interim reports. Because of this reporting environment, the issue of independent auditor association with interim financial reports remains problematic.

Two distinct views of interim reporting have been advocated, particularly by US and UK standard setters, although some believe that this distinction is more apparent than real. The first view holds that the interim period is an integral part of the annual accounting period (the *integral* view), while the second views the interim period as a unique accounting period of its own (the *discrete* view). Depending on which view is accepted, expenses would either be recognized as incurred, or would be allocated to the interim periods based on forecasted annual activity levels such as sales volume. The integral approach would require more use of estimation, and forecasts of full-year performance would be necessary antecedents for the preparation of interim reports.

<b>Sources of IFRS</b>
<div style="display: flex; justify-content: space-between;"> <span>IAS 1, 34</span> <span>IFRIC 10</span> </div> <p style="text-align: center; margin-top: 5px;"><i>IASB's Framework for the Preparation and Presentation of Financial Statements</i></p>

## DEFINITIONS OF TERMS

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**Estimated annual effective tax rate.** An expected annual tax rate which reflects estimates of annual earnings, tax rates, tax credits, etc.

**Interim financial report.** An interim financial report refers to either a complete set of financial statements for an interim period (prepared in accordance with the requirements of IAS 1), or a set of condensed financial statements for an interim period (prepared in accordance with the requirements of IAS 34).

**Interim period.** A financial reporting period shorter than a full financial year (e.g., a period of three or six months).

**Last-12-months reports.** Financial reporting for the 12-month period which ends on a given interim date.

**Seasonality.** The normal, expected occurrence of a major portion of revenues or costs in one or two interim periods.

**Year-to-date reports.** Financial reporting for the period which begins on the first day of the fiscal year and ends on a given interim date.

## ALTERNATIVE CONCEPTS OF INTERIM REPORTING

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The argument is often made that interim reporting is generically unlike financial reporting covering a full fiscal year. Two distinct views of interim reporting have developed, representing alternative philosophies of financial reporting. Under the first view, the interim period is considered to be an integral part of the annual accounting period. This view directs that annual operating expenses are to be estimated and then allocated to the interim periods based on forecasted annual activity levels, such as expected sales volume. When this

approach is employed, the results of subsequent interim periods must be adjusted to reflect prior estimation errors.

Under the second view, each interim period is considered to be a discrete accounting period, with status equal to a fiscal year. Thus, no estimations or allocations that are different from those used for annual reporting are to be made for interim reporting purposes. The same expense recognition rules should apply as under annual reporting, and no special interim accruals or deferrals are to be permitted. Annual operating expenses are recognized in the interim period in which they are incurred, irrespective of the number of interim periods benefited, unless deferral or accrual would be called for in the annual financial statements.

Proponents of the integral view argue that the unique expense recognition procedures are necessary to avoid creating possibly misleading fluctuations in period-to-period results. Using the integral view results in interim earnings which are hopefully more indicative of annual earnings and, thus, useful for predictive and other decision-making purposes. Proponents of the discrete view, on the other hand, argue that the smoothing of interim results for purposes of forecasting annual earnings has undesirable effects. For example, a turning point in an earnings trend that occurred during the year may be obscured.

Yet others have noted that the distinction between the integral and the discrete approaches is arbitrary and, in fact, rather meaningless. These critics note that interim periods bear the same relationship to full years as fiscal years due to longer intervals in the life cycle of a business, and that all periodic financial reporting necessitates the making of estimates and allocations. Direct costs and revenues are best accounted for as incurred and earned, respectively, which equates a discrete approach in most instances, while many indirect costs are more likely to require that an allocation process be applied, which is suggestive of an integral approach. In short, a mix of methods will be necessary as dictated by the nature of the cost or revenue item being reported upon, and neither a pure integral nor a pure discrete approach could be utilized in practice. The IFRS on interim financial reporting, IAS 34, does, in fact, adopt a mix of the discrete and the integral views, as described more fully below.

## **OBJECTIVES OF INTERIM FINANCIAL REPORTING**

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The purpose of interim financial reporting is to provide information that will be useful in making economic decisions (as, of course, is the purpose of annual financial information). Furthermore, interim financial reporting is expected to provide information specifically about the financial position, performance and change in financial position of an entity. The objective is general enough to embrace the preparation and presentation of either full financial statements or condensed information.

While accounting is often criticized for looking at an entity's performance through the rearview mirror, in fact it is well understood by standard setters that to be useful, such information must provide insights into future performance. As outlined in the objective of the IASB's standard on interim financial reporting, IAS 34, the primary, but not exclusive, purpose of timely interim period reporting is to provide interested parties (e.g., investors and creditors) with an understanding of the entity's earnings-generating capacity and its cash-flow-generating capacity, which are clearly future-oriented. Furthermore, the interim data is expected to give interested parties not only insights into such matters as seasonal volatility or irregularity, and provide timely notice about changes in patterns or trends, both as to income or cash-generating behaviour, but also into such balance-sheet-based phenomena as liquidity.

In reaching the positions set forth in the standard, the International Accounting Standards Committee (IASC, predecessor of the IASB) had considered the importance of interim reporting in identifying the turning points in an entity's earnings or liquidity. It was concerned that the integral approach to interim reporting can mask these turning points and thereby prevent users of the financial statements from taking appropriate actions. If this observation is correct, this would be an important reason to endorse the discrete view. In fact, the extent to which application of an integral approach masks turning points is probably related to the extent of "smoothing" applied to revenue and expense data.

It seems quite reasonable that interim reporting in conformity with the integral view, if done sensitively, could reveal turning points as effectively as would reports prepared under the discrete approach. As support for this assertion, one can consider national economic statistics (e.g., gross national product, unemployment), which are most commonly reported on seasonally adjusted bases, which is analogous to the consequence of utilizing an integral approach to interim reporting of entity financial information. Such economic data is often quite effective at highlighting turning points and is accordingly employed far more typically than is unadjusted monthly data, which would be roughly comparable to reporting under the discrete approach.

While the objectives of interim reporting are highly consistent with those of annual financial reporting, there are further concerns. These involve matters of cost and timeliness, as well as questions of materiality and measurement accuracy. In general, the belief has been that to be truly useful, the information must be produced in a more timely fashion than is often the case with annual reports (although other research suggests that users' tolerance for delayed information is markedly declining in all arenas), and that some compromises in terms of accuracy may be warranted in order to achieve greater timeliness.

## **APPLICATION OF ACCOUNTING POLICIES**

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There is no requirement under IFRS that entities must prepare interim financial statements. Furthermore, even if annual financial statements are prepared in accordance with IFRS, the reporting entity is free to present interim financial statements on bases other than IFRS, as long as they are not misrepresented as being IFRS compliant.

If interim financial statements are IFRS-based, IAS 34 states that interim financial data should be prepared in conformity with accounting policies used in the most recent annual financial statements. The only exception noted is when a change in accounting policy has been adopted since the last year-end financial report was issued. The standard also stipulates that the definitions of assets, liabilities, income and expenses for the interim period are to be identical to those applied in annual reporting situations.

While IAS 34, in many instances, is quite forthright about declaring its allegiance to the discrete view of interim financial reporting, it does incorporate a number of important exceptions to the principle.

### ***Consistency***

The standard logically states that interim period financial statements should be prepared using the same accounting principles that had been employed in the most recent annual financial statements. This is consistent with the idea that the latest annual report provides the frame of reference that will be employed by users of the interim information. The fact that interim data is expected to be useful in making projections of the forthcoming full-year's

reported results of operations makes consistency of accounting principles between the interim period and prior year important, since the projected results for the current year will undoubtedly be evaluated in the context of year-earlier performance. Unless the accounting principles applied in both periods are consistent, any such comparison is likely to be impeded.

The decision to require consistent application of accounting policies across interim periods and in comparison with the earlier fiscal year is a logical implication of the view of interim reporting as being largely a means of predicting the next fiscal year's results. It is also driven by the conclusion that those interim reporting periods stand alone (rather than being merely an integral portion of the full year). To put it differently, when an interim period is seen as an integral part of the full year, it is easier to rationalize applying different accounting policies to the interim periods, if doing so will more meaningfully present the results of the portion of the full year within the boundaries of the annual reporting period. For example, deferral of certain costs at interim statement of financial position dates, notwithstanding the fact that such costs could not validly be deferred at year-end, might theoretically serve the purpose of providing a more accurate predictor of full-year results.

On the other hand, if each interim period is seen as a discrete unit to be reported upon without having to serve the higher goal of providing an accurate prediction of the full-year's expected outcome, then a decision to depart from previously applied accounting principles is less easily justified. Given IAS 34's clear preference for the discrete view of interim financial reporting, its requirement regarding consistency of accounting principles is entirely logical.

#### ***Consolidated reporting requirement***

The standard also requires that, if the entity's most recent annual financial statements were presented on a consolidated basis, then the interim financial reports in the immediate succeeding year should also be presented similarly. This is entirely in keeping with the notion of consistency of application of accounting policies. The rule does not, however, either preclude or require publishing additional "parent company only" interim reports, even if the most recent annual financial statements did include such additional financial statements.

#### **Materiality as Applied to Interim Financial Statements**

Materiality is one of the most fundamental concepts underlying financial reporting. At the same time, it has largely been resistant to attempts at precise definition. Some IFRS do require that items be disclosed if material or significant, or if of "such size" as would warrant separate disclosure. Guidelines for performing an arithmetical calculation of a threshold for materiality (in order to measure "such size") are not prescribed in IAS 1, or for that matter in any other IFRS. Rather, this determination is left to the devices of each individual charged with responsibility for financial reporting.

IAS 34 advanced the notion that materiality for interim reporting purposes may differ from that defined in the context of an annual period. This follows from the decision to endorse the discrete view of interim financial reporting, generally. Thus, for example, discontinuing operations would have to be evaluated for disclosure purposes against whatever benchmark, such as gross revenue, is deemed appropriate as that item is being reported in the interim financial statements—not as it was shown in the prior year's financial statements or is projected to be shown in the current full-year's results.

The effect of the foregoing would normally be to lower the threshold level for reporting such items. Thus, it is deemed likely that some items separately set forth in the interim

financials may not be so presented in the subsequent full-year's annual report that includes that same interim period.

The objective is not to mislead the user of the information by failing to include a disclosure that might appear to be material within the context of the interim report, since that is the user's immediate frame of reference. If later the threshold is raised and items previously presented are no longer deemed worthy of such attention, this is not thought to create a risk of misleading the user, in contrast to a failure to disclose an item in the interim financial statements that measured against the performance parameters of the interim period might appear significant.

#### **Example of interim period materiality consideration**

To illustrate, assume that Xanadu Corp. has gross revenues of €2.8 million in the first fiscal quarter and will, in fact, go on to generate revenues of €12 million for the full year. Traditionally, for this company's financial reporting, materiality is defined as 5% of revenues. If in the first quarter income from discontinued operations amounting to €200,000 is earned, this should be separately set forth in the quarterly financial statements since it exceeds the defined 5% threshold for materiality. If there are no other discontinued operations results for the balance of the year, it might validly be concluded that disclosure in the year-end financials may be omitted, since the €200,000 income item is not material in the context of €12 million of full-year revenues. Thus, Xanadu's first quarter report might detail the discontinued operations, but that is later subsumed in continuing operations in the annual financial statements.

## **PRESENTATION**

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### ***Content of an interim financial report***

Instead of repeating information previously presented in annual financial statements, interim financial reports should preferably focus on new activities, events and circumstances that have occurred since the date of publication of the latest complete set of financial statements. IAS 34 recognizes the need to keep financial statement users informed about the latest financial condition of the reporting entity, and has thus moderated the presentation and disclosure requirements in the case of interim financial reports. Thus, in the interest of timeliness and with a sensitivity to cost considerations, and also to avoid repetition of information previously (and recently) reported, the standard allows an entity, at its option, to provide information relating to its financial position in a condensed format, in lieu of comprehensive information provided in a complete set of financial statements prepared in accordance with IAS 1. The minimum requirements as to the components of the interim financial statements to be presented (under this option) and their content are discussed later.

IAS 34 sets forth the following three important aspects of interim financial reporting:

- That by permitting presentation of condensed financial information, the standard is not intended to either prohibit or discourage the reporting entity from presenting a complete set of interim financial statements, as defined by IAS 1;
- That even when the choice is made to present condensed interim financial statements, if an entity chooses to add line items or additional explanatory notes to the condensed financial statements, over and above the minimum prescribed by this standard, the standard does not, in any way, prohibit or discourage the addition of such extra information; and

- That the recognition and measurement guidance in IAS 34 applies equally to a complete set of interim financial statements as to condensed interim financial statements. Thus, a complete set of interim financial statements would include not only the disclosures specifically prescribed by this standard, but also disclosures required by other IFRSs. For example, disclosures required by IFRS 7, such as those pertaining to interest rate risk or credit risk, would need to be incorporated in a complete set of interim financial statements, in addition to the selected note disclosures prescribed by IAS 34.

### ***Minimum components of an interim financial report***

IAS 34 sets forth minimum requirements in relation to condensed interim financial reports. The standard mandates that the following financial statements components be presented when an entity opts for the condensed format:

- A condensed statement of financial position;
- A condensed statement of profit or loss and other comprehensive income, either as:
  - A condensed single statement; or
  - A condensed separate statement of profit or loss and a condensed statement of comprehensive income;
- A condensed statement of changes in equity;
- A condensed statement of cash flows; and
- Selected explanatory notes.

### ***Form and content of interim financial statements***

1. IAS 34 mandates that if an entity chooses to present the “complete set of (interim) financial statements” instead of opting for the allowed method of presenting only “condensed” interim financial statements, then the form and content of those statements should conform to the requirements set by IAS 1 for a complete set of financial statements.
2. However, if an entity opts for the condensed format approach to interim financial reporting, then IAS 34 requires that, at a minimum, those condensed financial statements include each of the headings and the subtotals that were included in the entity’s most recent annual financial statements, along with selected explanatory notes, as prescribed by the standard.

It is interesting to note that IAS 34 mandates expansiveness in certain cases. The standard notes that extra line items or notes may need to be added to the minimum disclosures prescribed above, if their omission would make the condensed interim financial statements misleading. This concept can be best explained through the following illustration:

At December 20XX-1, an entity’s comparative statement of financial position had trade receivables that were considered doubtful, and hence, were fully reserved as of that date. Thus, on the face of the statement of financial position as of December 31, 20XX-1, the amount disclosed against trade receivables, net of provision, was a zero balance (and the comparative figure disclosed as of December 31, 20XX-2, under the prior year column was a positive amount, since at that earlier point of time, that is, at the end of the previous year, a small portion of the receivable was still considered collectible). At December 31, 20XX-1, the fact that the receivable (net of the provision) ended up being presented as a zero balance on the face of the statement of financial position was well explained in the

notes to the annual financial statements (which clearly showed the provision being deducted from the gross amount of the receivable that caused the resulting figure to be a zero balance that was then carried forward to the statement of financial position). If at the end of the first quarter of the following year the trade receivables were still doubtful of collection, thereby necessitating creation of a 100% provision against the entire balance of trade receivables as of March 31, 20XX, and the entity opted to present a condensed statement of financial position as part of the interim financial report, it would be misleading in this case to disclose the trade receivables as of March 31, 20XX, as a zero balance, without adding a note to the condensed statement of financial position explaining this phenomenon.

3. IAS 34 requires disclosure of earnings per share (both basic EPS and diluted EPS) on the face of the interim statement of comprehensive income. This disclosure is mandatory whether condensed or complete interim financial statements are presented. However, since EPS is only required (by IAS 33) for publicly-held companies, it is likewise only mandated for interim financial statements of such reporting entities.
4. IAS 34 mandates that an entity should follow the same format in its interim statement showing changes in equity as it did in its most recent annual financial statements.
5. IAS 34 requires that an interim financial report be prepared on a consolidated basis if the entity's most recent annual financial statements were consolidated statements. Regarding presentation of separate interim financial statements of the parent company in addition to consolidated interim financial statements, if they were included in the most recent annual financial statements, this standard neither requires nor prohibits such inclusion in the interim financial report of the entity.

### ***Significant events and transactions***

While a number of notes would potentially be required at an interim date, there could clearly be far less disclosure than is prescribed under other IFRS. IAS 34 reiterates that it is superfluous to provide the same notes in the interim financial report that appeared in the most recent annual financial statements, since financial statement users are presumed to have access to those statements in all likelihood. To the contrary, the interim financial report provides an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the last annual reporting. This information updates the relevant information presented in the most recent annual financial report. In keeping with this line of thinking, the following is a non-exhaustive list of events and transactions that are disclosed, if they are significant:

1. The write-down of inventories to net realizable value and any reversal.
2. Losses from the impairment of financial assets, property, plant and equipment, intangible or other assets and any reversal.
3. The reversal of any provision for restructuring cost.
4. Acquisitions and disposal of property, plant and equipment.
5. Commitments for the purchase of property, plant and equipment.
6. Litigation settlements.
7. Corrections of prior period errors.
8. Changes in the business or economic circumstances that effect the entity's financial assets and liabilities (recognized at fair value or amortized cost).
9. Any loan default or breach of a loan agreement that has not been remedied.



10. Related-party transactions.
11. Transfers between levels of the fair value hierarchy used for the measuring of financial instruments.
12. Changes in the classification of financial assets due to changes in purpose or use.
13. Changes in contingent liabilities and contingent assets.

### ***Other disclosures***

The following additional disclosure must also be provided in the notes to the interim financial statements on a financial year-to-year basis:

1. A statement that the same accounting policies and methods of computation are applied in the interim financial statements compared with the most recent annual financial statements, or if those policies or methods have changed, a description of the nature and effect of the change;
2. Explanatory comments about seasonality or cyclicity of interim operations;
3. The nature and magnitude of significant items affecting interim results that are unusual because of nature, size or incidence;
4. Dividends paid, either in the aggregate or on a per-share basis, presented separately for ordinary (common) shares and other classes of shares;
5. The following segment information:
  - Revenues from external customers and intersegment revenue if reported to the chief operating decision maker.
  - A measure of profit or loss.
  - Total assets and total liabilities (if these amounts are provided to the CODM on a regular basis and secondly, there has been a significant change in the amount disclosed in the last annual financial statements for that segment).
  - A description of any change in the basis of segmentation or in the basis of measuring segment profits.
  - A reconciliation of the total segments' profit or loss to the entity's profit or loss before tax and discontinued operations (or after tax if used).
6. Any events occurring subsequent to the end of the interim period;
7. Issues, repurchases and repayments of debt and equity securities;
8. The nature and quantum of changes in estimates of amounts reported in prior interim periods of the current financial year, or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period; and
9. The effect of changes in the composition of the entity during the interim period, like business combinations, acquisitions or disposal of subsidiaries, and long-term investments, restructuring and discontinuing operations.

Finally, in the case of a complete set of interim financial statements, the standard allows additional disclosures mandated by other IFRS. However, if the condensed format is used, then additional disclosures required by other IFRS are *not* required.

### ***Comparative interim financial statements***

IAS 34 endorses the concept of comparative reporting, which is generally acknowledged to be more useful than is the presentation of information about only a single period. IAS 34 furthermore mandates not only comparative (condensed or complete) interim statements of

comprehensive income (e.g., the second quarter of 2014 presented together with the second quarter of 2013), but the inclusion of year-to-date information as well (e.g., the first half of 2014 and also the first half of 2013). Thus, an interim statement of comprehensive income would ideally be comprised of four columns of data. On the other hand, in the case of the remaining components of interim financial statements (i.e., statement of financial position, statement of cash flows, and statement of changes in equity), the presentation of two columns of data would meet the requirements of IAS 34. Thus, the other components of the interim financial statements should present the following data for the two periods:

- The statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding fiscal year (*not* as of the comparable year-earlier date);
- The statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year; and
- IAS 34 requires that the statement showing changes in equity cumulatively for the current financial year to date be presented, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

The following illustration should amply explain the above-noted requirements of IAS 34.

XYZ Limited presents quarterly interim financial statements and its financial year ends on December 31 each year. For the second quarter of 20XX, XYZ Limited should present the following financial statements (condensed or complete) as of June 30, 20XX:

1. A statement of comprehensive income with four columns, presenting information for the three-month periods ended June 30, 20XX, and June 30, 20XX-1; and for the six-month periods ended June 30, 20XX, and June 30, 20XX-1.
2. A statement of financial position with two columns, presenting information as of June 30, 20XX, and as of December 31, 20XX-1.
3. A statement of cash flows with two columns presenting information for the six-month periods ended June 30, 20XX, and June 30, 20XX-1.
4. A statement of changes in equity with two columns presenting information for the six-month periods ended June 30, 20XX, and June 30, 20XX-1.

IAS 34 recommends that, for highly seasonal businesses, the inclusion of additional statement of comprehensive income columns for the 12 months ending on the date of the most recent interim report (also referred to as rolling 12-month statements) would be deemed very useful. The objective of recommending rolling 12-month statements is that seasonality concerns would be thereby eliminated, since by definition each rolling period contains all the seasons of the year. (Rolling statements, however, cannot correct cyclicity that encompasses more than one year, such as that of secular business expansions and recessions.) Accordingly, IAS 34 encourages companies affected by seasonality to consider including these additional statements, which could result in an interim statement of comprehensive income comprising six or more columns of data.

## RECOGNITION ISSUES

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### *General concepts*

The definitions of assets, liabilities, income and expense are the same for interim period reporting as at year-end reporting. These items are defined in the IASB's *Framework*.

The effect of stipulating that the same definitions apply to interim reporting is to further underscore the concept of interim periods being discrete units of time upon which the statements report. For example, given the definition of assets as resources generating future economic benefits for the entity, expenditures that could not be capitalized at year-end because of a failure to meet this definition could similarly not be deferred at interim dates. Thus, by applying the same definitions at interim dates, IAS 34 has mandated the same recognition rules as are applicable at the end of full annual reporting periods.

However, while the overall implication is that identical recognition and measurement rules are to be applied to interim financial statements, there are a number of exceptions and modifications to the general rule. Some of these are in simple acknowledgment of the limitations of certain measurement techniques, and the recognition that applying those definitions at interim dates might necessitate interpretations different from those useful for annual reporting. In other cases, the standard clearly departs from the discrete view, since such departures are not only wise, but probably fully necessary. These specific recognition and measurement issues are addressed below.

### ***Recognition of annual costs incurred unevenly during the year***

It is frequently observed that certain types of costs are incurred in uneven patterns over the course of a fiscal year, while not being driven strictly by variations in volume of sales activity. For example, major expenditures on advertising may be prepaid at the inception of the campaign; tooling for new product production will obviously be heavily weighted to the preproduction and early production stages. Certain discretionary costs, such as research and development, will not bear any predictable pattern or necessary relationship with other costs or revenues.

If an integral view approach had been designated by IAS 34, there would be potent arguments made in support of the accrual or deferral of certain costs. For instance, if a major expenditure for overhauling equipment is scheduled to occur during the final interim period, logic could well suggest that the expenditure should be anticipated in the earlier interim periods of the year, if those periods were seen as integral parts of the fiscal year. Under the discrete view adopted by the standard, however, such an accrual would be seen as an inappropriate attempt to smooth the operating results over all the interim periods constituting the full fiscal year. Accordingly, such anticipation of future expenses is prohibited, unless the future expenditure gives rise to a true liability in the current period, or meets the test of being a contingency which is probable and the magnitude of which is reasonably estimable.

For example, many business entities grant bonuses to managers only after the annual results are known; even if the relationship between the bonuses and the earnings performance is fairly predictable from past behaviour, these remain discretionary in nature and need not be granted. Such a bonus arrangement would not give rise to a liability during earlier interim periods, inasmuch as the management has yet to declare that there is a commitment that will be honoured. (Compare this with the situation where managers have contracts specifying a bonus plan, which clearly would give rise to a legal liability during the year, albeit one which might involve complicated estimation problems. Also, a bonus could be anticipated for interim reporting purposes if it could be considered a constructive obligation, for example, based upon past practice for which the entity has no realistic alternative, and assuming that a realistic estimate of that obligation can be made.)

Another example involves contingent lease arrangements. Often in operating lease situations the lessee will agree to a certain minimum or base rent, plus an amount that is tied

to a variable such as sales revenue. This is typical, for instance, in retail rental contracts, such as for space in shopping malls, since it encourages the landlord to maintain the facilities in an appealing fashion so that tenants will be successful in attracting customers. Only the base amount of the periodic rental is a true liability, unless and until the higher rent becomes payable as defined sales targets are actually achieved. If contingent rents are payable based on a sliding scale (e.g., 1% of sales volume up to €500,000, then 2% of amounts up to €1.5 million, etc.), the projected level of full-year sales should not be used to compute rental accruals in the early periods; rather, only the contingent rents payable on the actual sales levels already achieved should be so recorded.

The foregoing examples were clearly categories of costs that, while often fairly predictable, would not constitute a legal obligation of the reporting entity until the associated conditions were fully met. There are, however, other examples that are more ambiguous. Paid vacation time and holiday leave are often enforceable as legal commitments, and if this is so, provision for these costs should be made in the interim financial statements. In other cases, as when company policy is that accrued vacation time is lost if not used by the end of a defined reporting year, such costs might not be subject to accrual under the discrete view. The facts of each such situation would have to be carefully analysed to make a proper determination.

#### ***Revenues received seasonally, cyclically or occasionally***

IAS 34 is clear in stipulating that revenues such as dividend income and interest earned cannot be anticipated or deferred at interim dates, unless such practice would be acceptable under IFRS at year-end. Thus, interest income is typically accrued, since it is well established that this represents a contractual commitment. Dividend income, on the other hand, is not recognized until declared, since even when highly predictable based on past experience, these are not obligations of the paying corporation until actually declared.

Furthermore, seasonality factors should not be smoothed out of the financial statements. For example, for many retail stores a high percentage of annual revenues occur during the holiday shopping period, and the quarterly or other interim financial statements should fully reflect such seasonality. That is, revenues should be recognized as they occur.

#### ***Income taxes***

The fact that income taxes are assessed annually by the taxing authorities is the primary reason for reaching the conclusion that taxes are to be accrued based on the estimated average annual effective tax rate for the full fiscal year. Further, if rate changes have been enacted to take effect later in the fiscal year (while some rate changes take effect in midyear, more likely this would be an issue if the entity reports on a fiscal year and the new tax rates become effective at the start of a calendar year), the expected effective rate should take into account the rate changes as well as the anticipated pattern of earnings to be experienced over the course of the year. Thus, the rate to be applied to interim period earnings (or losses, as discussed further below) will take into account the expected level of earnings for the entire forthcoming year, as well as the effect of enacted (or substantially enacted) changes in the tax rates to become operative later in the fiscal year. In other words, and as the standard puts it, the estimated average annual rate would “reflect a blend of the progressive tax rate structure expected to be applicable to the full year’s earnings including enacted or substantially enacted changes in the income tax rates scheduled to take effect later in the financial year.”

IAS 34 addresses in detail the various computational aspects of an effective interim period tax rate which are summarized in the following paragraphs.

***Multiplicity of taxing jurisdictions and different categories of income***

Many entities are subject to a multiplicity of taxing jurisdictions, and in some instances the amount of income subject to tax will vary from one to the next, since different laws will include and exclude disparate items of income or expense from the tax base. For example, interest earned on government-issued bonds may be exempted from tax by the jurisdiction that issued them, but be defined as fully taxable by other tax jurisdictions the entity is subject to. To the extent feasible, the appropriate estimated average annual effective tax rate should be separately ascertained for each taxing jurisdiction and applied individually to the interim period pre-tax income of each jurisdiction, so that the most accurate estimate of income taxes can be developed at each interim reporting date. In general, an overall estimated effective tax rate will not be as satisfactory for this purpose as would a more carefully constructed set of estimated rates, since the pattern of taxable and deductible items will fluctuate from one period to the next.

Similarly, if the tax law prescribes different income tax rates for different categories of income (such as the tax rate on capital gains which usually differs from the tax rate applicable to business income in many countries), then to the extent practicable, a separate tax rate should be applied to each category of interim period pre-tax income. The standard, while mandating such detailed rules of computing and applying tax rates across jurisdictions or across categories of income, recognizes that in practice such a degree of precision may not be achievable in all cases. Thus, in all such cases, IAS 34 softens its stand and allows usage of a “weighted-average of rates across jurisdictions or across categories of income” provided “it is a reasonable approximation of the effect of using more specific rates.”

***Tax credits***

In computing an expected effective tax rate for a given tax jurisdiction, all relevant features of the tax regulations should be taken into account. Jurisdictions may provide for tax credits based on new investment in plant and machinery, relocation of facilities to backward or underdeveloped areas, research and development expenditures, levels of export sales and so forth, and the expected credits against the tax for the full year should be given consideration in the determination of an expected effective tax rate. Thus, the tax effect of new investment in plant and machinery, when the local taxing body offers an investment credit for qualifying investment in tangible productive assets, will be reflected in those interim periods of the fiscal year in which the new investment occurs (assuming it can be forecast to occur later in a given fiscal year), and not merely in the period in which the new investment occurs. This is consistent with the underlying concept that taxes are strictly an annual phenomenon, but it is at variance with the purely discrete view of interim financial reporting.

IAS 34 notes that, although tax credits and similar modifying elements are to be taken into account in developing the expected effective tax rate to apply to interim earnings, tax benefits which will relate to onetime events are to be reflected in the interim period when those events take place. This is perhaps most likely to be encountered in the context of capital gains taxes incurred in connection with occasional dispositions of investments and other capital assets; since it is not feasible to project the rate at which such transactions will occur over the course of a year, the tax effects should be recognized only as the underlying events transpire.

While in most cases tax credits are to be handled as suggested in the foregoing paragraphs, in some jurisdictions tax credits, particularly those that relate to export revenue or capital expenditures, are in effect government grants. The accounting for government grants is set forth in IAS 20; in brief, grants are recognized in income over the period

necessary to properly match them to the costs which the grants are intended to offset or defray. Thus, compliance with both IAS 20 and IAS 34 would necessitate that tax credits be carefully analysed to identify those which are, in substance, grants, and then accounting for the credit consistent with its true nature.

### ***Tax loss tax credit carrybacks and carryforwards***

When an interim period loss gives rise to a tax loss carryback, it should be fully reflected in that interim period. Similarly, if a loss in an interim period produces a tax loss carryforward, it should be recognized immediately, but only if the criteria set forth in IAS 12 are met. Specifically, it must be deemed probable that the benefits will be realizable before the loss benefits can be given formal recognition in the financial statements. In the case of interim period losses, it may be necessary to assess not only whether the entity will be profitable enough in future fiscal years to utilize the tax benefits associated with the loss, but, furthermore, whether interim periods later in the same year will provide earnings of sufficient magnitude to absorb the losses of the current period.

IAS 12 provides that changes in expectations regarding the realizability of benefits related to net operating loss carryforwards should be reflected currently in tax expense. Similarly, if a net operating loss carryforward benefit is not deemed probable of being realized until the interim (or annual) period when it in fact becomes realized, the tax effect will be included in tax expense of that period. Appropriate explanatory material must be included in the notes to the financial statements, even on an interim basis, to provide the user with an understanding of the unusual relationship between pre-tax accounting income and the provision for income taxes.

### ***Volume rebates or other anticipated price changes in interim reporting periods***

IAS 34 prescribes that where volume rebates or other contractual changes in the prices of goods and services are anticipated to occur over the annual reporting period, these should be anticipated in the interim financial statements for periods within that year. The logic is that the effective cost of materials, labour, or other inputs will be altered later in the year as a consequence of the volume of activity during earlier interim periods, among others, and it would be a distortion of the reported results of those earlier periods if this were not taken into account. Clearly this must be based on estimates, since the volume of purchases, etc., in later portions of the year may not materialize as anticipated. As with other estimates, however, as more accurate information becomes available this will be adjusted on a prospective basis, meaning that the results of earlier periods should not be revised or corrected. This is consistent with the accounting prescribed for contingent rentals and is furthermore consistent with IAS 37's guidance on provisions.

The requirement to take volume rebates and similar adjustments into effect in interim period financial reporting applies equally to vendors or providers, as well as to customers or consumers of the goods and services. In both instances, however, it must be deemed probable that such adjustments have been earned or will occur, before giving recognition to them in the financials. This high a threshold has been set because the definitions of assets and liabilities in the IASB's *Framework* require that they be recognized only when it is probable that the benefits will flow into or out from the entity. Thus, accrual would only be appropriate for contractual price adjustments and related matters. Discretionary rebates and other price adjustments, even if typically experienced in earlier periods, would not be given formal recognition in the interim financials.

### ***Depreciation and amortization in interim periods***

The rule regarding depreciation and amortization in interim periods is more consistent with the discrete view of interim reporting. Charges to be recognized in the interim periods are to be related to only those assets actually employed during the period; planned acquisitions for later periods of the fiscal year are not to be taken into account.

While this rule seems entirely logical, it can give rise to a problem that is not encountered in the context of most other types of revenue or expense items. This occurs when the tax laws or financial reporting conventions permit or require that special allocation formulas be used during the year of acquisition (and often disposition) of an asset. In such cases, depreciation or amortization will be an amount other than the amount that would be computed based purely on the fraction of the year the asset was in service. For example, assume that convention is that one-half year of depreciation is charged during the year the asset is acquired, irrespective of how many months it is in service. Further assume that a particular asset is acquired at the inception of the fourth quarter of the year. Under the requirements of IAS 34, the first three quarters would not be charged with any depreciation expense related to this asset (even if it was known in advance that the asset would be placed in service in the fourth quarter). However, this would then necessitate charging fourth quarter operations with one-half year's (i.e., two quarters') depreciation, which arguably would distort that final period's results of operations.

IAS 34 does address this problem area. It states that an adjustment should be made in the final interim period so that the sum of interim depreciation and amortization equals an independently computed annual charge for these items. However, since there is no requirement that financial statements be separately presented for a final interim period (and most entities, in fact, do not report for a final period), such an adjustment might be implicit in the annual financials, and presumably would be explained in the notes if material (the standard does not explicitly require this, however).

The alternative financial reporting strategy, that is, projecting annual depreciation, including the effect of asset dispositions and acquisitions planned for or reasonably anticipated to occur during the year, and then allocating this ratably to interim periods, has been rejected. Such an approach might have been rationalized in the same way that the use of the effective annual tax rate was in assigning tax expense or benefits to interim periods, but this has not been done.

### ***Inventories***

Inventories represent a major category for most manufacturing and merchandising entities, and some inventory costing methods pose unique problems for interim financial reporting. In general, however, the same inventory costing principles should be utilized for interim reporting as for annual reporting. However, the use of estimates in determining quantities, costs and net realizable values at interim dates will be more pervasive.

Two particular difficulties are addressed in IAS 34. These are the matters of determining net realizable values at interim dates and the allocation of manufacturing variances.

Regarding net realizable value determination, the standard expresses the belief that the determination of NRV at interim dates should be based on selling prices and costs to complete at those dates. Projections should therefore not be made regarding conditions which possibly might exist at the time of the fiscal year-end. Furthermore, write-downs to NRV taken at interim reporting dates should be reversed in a subsequent interim reporting period only if it would be appropriate to do so at the end of the financial year.

The last of the special issues related to inventories that are addressed by IAS 34 concerns allocation of variances at interim dates. When standard costing methods are employed, the resulting variances are typically allocated to cost of sales and inventories in proportion to the monetary magnitude of those two captions, or according to some other rational system. IAS 34 requires that the price, efficiency, spending and volume variances of a manufacturing entity are recognized in income at interim reporting dates to the extent those variances would be recognized at the end of the financial year. It should be noted that some national standards have prescribed deferral of such variances to year-end based on the premise that some of the variances will tend to offset over the course of a full fiscal year, particularly if the result of volume fluctuations due to seasonal factors. When variance allocation is thus deferred, the full balances of the variances are placed onto the statement of financial position, typically as additions to or deductions from the inventory accounts. However, IAS 34 expresses a preference that these variances be disposed of at interim dates (instead of being deferred to year-end) since to not do so could result in reporting inventory at interim dates at more or less than actual cost.

#### Example of interim reporting of product costs

Dakar Corporation encounters the following product cost situations as part of its quarterly reporting:

- It only conducts inventory counts at the end of the second quarter and end of the fiscal year. Its typical gross profit is 30%. The actual gross profit at the end of the second quarter is determined to have been 32% for the first six months of the year. The actual gross profit at the end of the year is determined to have been 29% for the entire year.
- It determines that, at the end of the second quarter, due to peculiar market conditions, there is a net realizable value (NRV) adjustment to certain inventory required in the amount of €90,000. Dakar expects that this market anomaly will be corrected by year-end, which indeed does occur in late December.
- It suffers a decline of €65,000 in the market value of its inventory during the third quarter. This inventory value increases by €75,000 in the fourth quarter.
- It suffers a clearly temporary decline of €10,000 in the market value of a specific part of its inventory in the first quarter, which it recovers in the second quarter.

Dakar uses the following calculations to record these situations and determine quarterly cost of goods sold:

	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>	<u>Full Year</u>
Sales	€10,000,000	€8,500,000	€7,200,000	€11,800,000	€37,500,000
(1 – Gross profit percentage)	70%		70%		
Cost of goods, gross profit method	7,000,000		5,040,000		
Cost of goods, based on actual physical count		5,580,000 <sup>1</sup>		9,005,000 <sup>2</sup>	26,625,000
Temporary net realizable value decline in specific inventory <sup>3</sup>		90,000		(90,000)	0
Decline in inventory value with subsequent increase <sup>4</sup>			65,000	(65,000)	0



Temporary decline in inventory value <sup>5</sup>	<u>10,000</u>	<u>(10,000)</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total cost of goods sold	<b><u>€7,010,000</u></b>	<b><u>€5,660,000</u></b>	<b><u>€5,105,000</u></b>	<b><u>€ 8,850,000</u></b>	<b><u>€26,625,000</u></b>

<sup>1</sup> Calculated as [ $€18,500,000 \text{ sales} \times (1 - 32\% \text{ gross margin})$ ] - €7,000,000 (Quarter 1 cost of sales)

<sup>2</sup> Calculated as [ $€37,500,000 \text{ sales} \times (1 - 29\% \text{ gross margin})$ ] - €17,620,000 (Quarters 1–3 cost of sales)

<sup>3</sup> Even though anticipated to recover, the NRV decline must be recognized.

<sup>4</sup> Full recognition of market value decline, followed by recognition of market value increase, but only in the amount needed to offset the amount of the initial decline.

<sup>5</sup> No deferred recognition to temporary decline in value.

### Example of interim reporting of other expenses

Dakar Corporation encounters the following expense situations as part of its quarterly reporting:

- Its largest customer, Festive Fabrics, has placed firm orders for the year that will result in sales of €1,500,000 in the first quarter, €2,000,000 in the second quarter, €750,000 in the third quarter and €1,650,000 in the fourth quarter. Dakar gives Festive Fabrics a 5% rebate if Festive Fabrics buys at least €5 million of goods each year. Festive Fabrics exceeded the €5 million goal in the preceding year and was expected to do so again in the current year.
- It incurs €24,000 of trade show fees in the first quarter for a trade show that will occur in the third quarter.
- It pays €64,000 *in advance* in the second quarter for a series of advertisements that will run through the third and fourth quarters.
- It receives a €32,000 property tax bill in the second quarter that applies to the *following* 12 months.
- It incurs annual factory air filter replacement costs of €6,000 in the first quarter.
- Its management team is entitled to a year-end bonus of €120,000 if it meets a sales target of €40 million, prior to any sales rebates, with the bonus dropping by €10,000 for every million dollars of sales not achieved.

Dakar uses the following calculations to record these situations:

	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>	<u>Full year</u>
Sales	€10,000,000	€8,500,000	€7,200,000	€11,800,000	€37,500,000
Deduction from sales	(75,000) <sup>1</sup>	(100,000)	(37,500)	(82,500)	(295,000)
Marketing expense			24,000 <sup>2</sup>		24,000
Advertising expense			32,000 <sup>3</sup>	32,000	64,000
Property tax expense		8,000 <sup>4</sup>	8,000	8,000	24,000
Maintenance expense	1,500 <sup>5</sup>	1,500	1,500	1,500	6,000
Bonus expense	30,000 <sup>6</sup>	25,500	21,600	17,900	95,000

<sup>1</sup> The sales rebate is based on 5% of the actual sales to the customer in the quarter when the sale is incurred. The actual payment back to the customer does not occur until the end of the year, when the €5 million goal is definitively reached. Since the firm orders for the full year exceed the threshold for rebates, the obligation is deemed probable and must be recorded.

<sup>2</sup> The €24,000 trade show payment is initially recorded as a prepaid expense and then charged to marketing expense when the trade show occurs.

<sup>3</sup> The €64,000 advertising payment is initially recorded as a prepaid expense and then charged to advertising expense when the advertisements run.

<sup>4</sup> The €32,000 property tax payment is initially recorded as a prepaid expense and then charged to property tax expense on a straight-line basis over the next four quarters.

<sup>5</sup> The €6,000 air filter replacement payment is initially recorded as a prepaid expense and then charged to maintenance expense over the one-year life of the air filters.

<sup>6</sup>The management bonus is recognized in proportion to the amount of revenue recognized in each quarter. Once it becomes apparent that the full sales target will not be reached, the bonus accrual should be adjusted downward. In this case, the downward adjustment is assumed to be in the fourth quarter, since past history and seasonality factors made non-achievement of the full goal unlikely until fourth quarter results were known. (Note: with other fact patterns, quarterly accruals may have differed.)

### Foreign Currency Translation Adjustments at Interim Dates

Given the IASC's embracing of the discrete view regarding interim reporting, it is not surprising that the same approach to translation gains or losses as is mandated at year-end would be adopted in IAS 34. IAS 21 prescribes rules for translating the financial statements for foreign operations into either the functional currency or the presentation currency and also includes guidelines for using historical, average or closing foreign exchange rates. It also lays down rules for either including the resulting adjustments in income or in equity. IAS 34 requires that consistent with IAS 21, the actual average and closing rates for the interim period be used in translating financial statements of foreign operations at interim dates. In other words, the future changes to exchange rates (in the current financial year) are not allowed to be anticipated by IAS 34.

Where IAS 21 provides for translation adjustments to be recognized in the statement of profit or loss and other comprehensive income in the period it arises, IAS 34 stipulates that the same approach be applied during each interim period. If the adjustments are expected to reverse before the end of the financial year, IAS 34 requires that entities not defer some foreign currency translation adjustments at an interim date.

### Adjustments to Previously Reported Interim Data

While year-to-date financial reporting is not required, although the standard does recommend it in addition to normal interim period reporting, the concept finds some expression in the standard's position that adjustments *not* be made to earlier interim periods' results. By measuring income and expense on a year-to-date basis, and then effectively backing into the most recent interim period's presentation by deducting that which was reported in earlier interim periods, the need for retrospective adjustment of information that was reported earlier is obviated. However, there may be the need for disclosure of the effects of such measurement strategies when this results effectively in including adjustments in the most current interim period's reported results.

#### Example of interim reporting of contingencies

Dakar Corporation is sued over its alleged violation of a patent in one of its products. Dakar settles the litigation in the fourth quarter. Under the settlement terms, Dakar must retroactively pay a 3% royalty on all sales of the product to which the patent applies. Sales of the product were €150,000 in the first quarter, €82,000 in the second quarter, €109,000 in the third quarter and €57,000 in the fourth quarter. In addition, the cumulative total of all sales of the product in prior years is €1,280,000. Under provisions of IAS 34, Dakar cannot restate its previously issued quarterly financial results to include the following royalty expense, so instead will report the royalties expense, including that for earlier years, in the fourth quarter:

	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>	<u>Full year</u>
Sales related to lawsuit	€150,000	€82,000	€109,000	€57,000	€398,000
Royalty expense	0	0	0	11,940	11,940
Royalty expense related to prior year sales	0			38,400	38,400

### Accounting Changes in Interim Periods

A change in accounting policy other than one for which the transition is specified by a new standard should be reflected by restating the financial statements of prior interim periods of the current year and the comparable interim periods of the prior financial year.

One of the objectives of this requirement of IAS 34 is to ensure that a single accounting policy is applied to a particular class of transactions throughout the entire financial year. To allow differing accounting policies to be applied to the same class of transactions within a single financial year would be troublesome since it would result in “interim allocation difficulties, obscured operating results, and complicated analysis and understandability of interim period information.”

The amendment to IFRS 1 as part of the 2010 *Improvements to IFRS* clarified that, if a first-time adopter changes its accounting policies or its use of the exemptions in IFRS 1 after it has published an interim financial report in accordance with IAS 34, *Interim Financial Reporting*, but before its first IFRS financial statements are issued, it should explain those changes and update the reconciliations between previous GAAP and IFRS.

### *Use of estimates in interim periods*

IAS 34 recognizes that preparation of interim financial statements will require a greater use of estimates than annual financial statements. Appendix C to the standard provides examples of use of estimates to illustrate the application of this standard in this regard. The Appendix provides nine examples covering areas ranging from inventories to pensions. For instance, in the case of pensions, the Appendix states that for interim reporting purposes, reliable measurement is often obtainable by extrapolation of the latest actuarial valuation, as opposed to obtaining the same from a professionally qualified actuary, as would be expected at the end of a financial year. Readers are advised to read the other illustrations contained in Appendix C of IAS 34 for further guidance on the subject.

### *Impairment of assets in interim periods*

IAS 34 stipulated that an entity was to apply the same impairment testing, recognition and reversal criteria at an interim period as it would at the end of its financial year. The frequency of interim financial reporting, however, was not to affect the annual financial statements. This prescription created unanticipated conflicts, since certain impairments were not, according to other standards, subject to later reversals.

One apparent conflict between IAS 34's directives and the IAS 36 requirement is that an impairment loss recognized on goodwill cannot be later reversed. If, for example, an impairment of goodwill were indicated in the first fiscal quarter, but at year-end that impairment no longer existed, it would be impossible to comply with the proscription against having interim reporting affect annual results unless the impairment in the first quarter were reversed later in the year.

Another apparent conflict pertained to the IAS 39 mandate that impairments recognized on financial assets carried at cost (e.g., unquoted equity instruments) could not be reversed. Furthermore, IAS 39 also stipulated that losses on available-for-sale equity securities, if recognized in profit or loss (i.e., those losses deemed other than temporary in nature), could not later be reversed into income.

To resolve these specific conflicts (and no others), IFRIC Interpretation 10, *Interim Financial Reporting and Impairment*, directs that impairments of goodwill recognized in

interim periods may not be later reversed, even if at year's end no impairment would otherwise have been reported. This interpretation therefore brings to an end the IAS 34-based mandate that the frequency of interim reporting cannot itself impact annual financial reporting.

IFRIC 10 also applies to losses recognized regarding equity securities classified as available-for-sale under IAS 39. That standard directs that, once written down as impaired by means of a charge against earnings, a subsequent increase in the fair value of available-for-sale equity securities, and for financial assets carried at cost (e.g., unquoted equity securities for which fair value cannot be reliably measured) cannot be recognized through income. For example, if an impairment is recognized in the second quarter of an entity's fiscal year, but the security's fair value has recovered by year's end, IAS 39 prohibits reporting the value increase in earnings. This conflicts with the IAS 34 prescription that frequency of interim reporting is not to affect annual results of operations. IFRIC 10 stipulates that an impairment loss recognized in connection with available-for-sale equity securities or financial instruments carried at cost cannot be reversed in subsequent interim periods. This is thus yet another mandate that conflicts with, and supersedes, the fundamental principle of IAS 34.

IFRS 9, issued in October 2010, amended a number of paragraphs under IFRIC 10. The revision of IFRIC 10 states that entities may not reverse an impairment loss recognized in a previous interim period in respect of goodwill. However, this restriction will not extend to other areas of potential conflict between IAS 34 and other standards.

### ***Interim financial reporting in hyperinflationary economies***

IAS 34 requires that interim financial reports in hyperinflationary economies be prepared using the same principles as at the financial year-end. Thus, the provisions of IAS 29 would need to be complied with in this regard. IAS 34 stipulates that in presenting interim data in the measuring unit, entities should report the resulting gain or loss on the net monetary position in the interim period's statement of comprehensive income. IAS 34 also requires that entities do not need to annualize the recognition of the gain or loss or use estimated annual inflation rates in preparing interim period financial statements in a hyperinflationary economy.

## **US GAAP COMPARISON**

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While both US GAAP and IFRS require interim reporting for public companies, there are significant differences with regard to how and when the elements of the financial statements are recognized and measured.

US GAAP requires that product-related or variable costs be recognized in full in the interim period as they are incurred, the same way that is required for annual financial statements. However, production cost allocation variances expected to be made up by the end of the period are deferred. Additionally, generally, practice and policies applied in annual periods shall be applied at interim periods. However, for other expenses, when the expenditure can be shown to clearly benefit a future period, the expense is allocated among those periods, resulting in deferral or accrual of certain costs. This is referred to as *smoothing*. Smoothing is done pursuant to the notion that an interim period is integral to the full fiscal period. IFRS regards each interim period as a discrete period. In other words under US GAAP, except for seasonal effects, each period should be predictive of the remaining periods of the fiscal year. Seasonal effects are disclosed. Entities are encouraged to present rolling

full-year results for material seasonal effects if doing so would improve comparability. However, if an expense is unusual or cannot be reasonably attributed to future periods, it is not deferred. Allocations of these costs to current and future periods cannot be arbitrary. The effective income tax rate is based on full-year income estimates. Changes in income tax rates are recognized in the current interim period, unless attributed to an error.

US GAAP is more explicit about the types of transactions that require disclosures related to fourth-quarter activity. In particular, the following fourth-quarter activity must be disclosed:

- Activity related to a change in accounting principle;
- Disposals of components of an entity;
- Extraordinary, unusual or infrequently occurring items recognized in the fourth quarter; and
- The aggregate effect of year-end adjustments that are material to the results of the fourth quarter.

US GAAP, unlike IFRS, does not allow decreases in inventory value recorded in annual financial statements to be reversed. However, for interim reporting, if the price of inventory rises in a subsequent interim period within the same fiscal year, a reversal gain is recognized up to the amount of previous losses. The LIFO method of inventory cost flow is prohibited under IFRS, but not under US GAAP. When a LIFO-layer liquidation is expected to be restored by the end of the year, a debit to inventory is made with an offset to current liabilities in the interim period and replacement costs of the inventory are recognized in cost of goods sold.

Materiality of an adjustment is determined with regard to the expected results for the fiscal year. IFRS uses the current interim period results. Similar to IFRS, costs that are accrued during the year because the amount is based on full-year activities (e.g., sales and purchase discounts, bonuses) are estimated and recognized at each interim period.

Under US GAAP, a statement of Changes in Equity is not required in interim financial statements.

meaningless, as would adding dollars, francs and marks. This is precisely the problem discussed earlier in this chapter, but raised to an exponential level.

In a truly hyperinflationary economy, users of financial statements are unable to make meaningful use of such statements unless they have been recast into currency units having purchasing power defined by prices at or near the date of the statements. Unless this common denominator is employed, the financial statements are too difficult to interpret for purposes of making management, investing and credit decisions. Although some sophisticated users, particularly in those countries where hyperinflation has been endemic, such as some of the South American nations, including Brazil and Argentina, and for certain periods nations such as Israel, are able to apply rules of thumb to cope with this problem, in general modifications must be made to general-purpose financial statements if they are to have any value.

Under international accounting standards, if hyperinflation is deemed to characterize the economy, a form of price level accounting must be applied to the financial statements to conform to generally accepted accounting principles. IAS 29 requires that all the financial statements be adjusted to reflect year-end general price levels, which entails applying a broad-based index to all non-monetary items on the statement of financial position and to all transactions reported in the statement of comprehensive income and the statement of cash flows.

### **Severe Hyperinflation According to IFRS 1**

In 2010 the IASB was asked to clarify how an entity should resume presenting financial statements in accordance with IFRS after a period of severe hyperinflation, during which the entity had been unable to comply with IAS 29, *Financial Reporting in Hyperinflationary Economies*. It should be noted that an entity would be unable to comply with IAS 29 if a reliable general price index is not available to all entities with that same functional currency, and exchangeability between the currency and a relatively stable foreign currency does not exist. However, once the functional currency changes to a non-hyperinflationary currency, or the currency ceases to be severely hyperinflationary, an entity would be able to start applying IFRS to subsequent transactions.

Sufficient guidance in these circumstances was not provided by the IFRS. Therefore IFRS 1 was amended to provide guidance on how an entity can present IFRS financial statements after its currency ceases to be severely hyperinflationary, by presenting an opening IFRS statement of financial position on or after the functional currency normalization date.

It was believed that allowing an entity to apply the exemption when presenting an opening IFRS statement of financial position after, and not just on, the functional currency normalization date, would address practical concerns that may arise if the functional currency normalization date and the entity's date of transition to IFRS are different. This amendment would also be available to entities that were emerging from a period of severe hyperinflation but had not applied IFRS in the past.

IFRS 1 permits an entity emerging from a period of severe hyperinflation to elect to measure its assets and liabilities at fair value. That fair value could then be used as the deemed cost in its opening IFRS statement of financial position. This approach expands the scope of the deemed cost exemptions in IFRS 1 to enable them to be applied in these specific circumstances. However, because severe hyperinflation is a specific set of circumstances, the IASB wanted to ensure that the fair value measurement option was applied only to those

assets and liabilities that were held before the functional currency normalization date, and not to other assets and liabilities held by the entity at the time it made the transition to IFRS. Furthermore, where a parent entity's functional currency has been subject to severe hyperinflation, but its subsidiary company's functional currency has not been subject to severe hyperinflation, IFRS 1 does not require such a subsidiary company to apply this exemption.

Any adjustments arising on electing to measure assets and liabilities at fair value in the opening IFRS statement of financial position arise from events and transactions before the date of transition to IFRS. Thus, an entity should recognize those adjustments directly in retained earnings (or, if appropriate, in another category of equity) at the date of transition to IFRS.

Entities are required to prepare and present comparative information in accordance with IFRS. Furthermore it should be noted that the preparation of information in accordance with IFRS for periods before the functional currency normalization date may not be possible; hence the exemption refers to a date of transition on or after the functional currency normalization date. This may lead to a comparative period of less than 12 months. Entities should consider whether disclosure of non-IFRS comparative information and historical summaries would provide useful information to users of financial statements. In all such cases entities should explain the transition to IFRS.

### **Restating Historical Cost Financial Statements under Hyperinflation Conditions**

The precise adjustments to be made depend on whether the financial reporting system is based on historical costs or on current costs. Although in both cases the goal is to restate the financial statements into the measuring unit that exists at the date of the statement of financial position, the mechanics will vary to some extent.

If the financial reporting system is based on historical costing, the process used to adjust the statement of financial position can be summarized as follows:

1. Monetary assets and liabilities are already presented in units of year-end purchasing power and receive no further adjustment. (See the appendix for a categorization of different assets and liabilities as to their status as monetary or non-monetary.)
2. Monetary assets and liabilities that are linked to price changes, such as indexed debt securities, are adjusted according to the terms of the contractual arrangement. This does not change the characterization of these items as monetary, but it does serve to reduce or even eliminate the purchasing power gain or loss that would have otherwise been experienced as a result of holding these items during periods of changing general prices.
3. Non-monetary items are adjusted by applying a ratio of indices, the numerator of which is the general price level index at the date of the statement of financial position and the denominator of which is the index as of the acquisition or inception date of the item in question. For some items, such as plant assets, this is a straightforward process, while for others, such as work-in-process inventories, this can be more complex.
4. Certain assets cannot be adjusted as described above, because even in nominally historical cost financial statements these items have been revised to some other basis, such as fair value or net realizable amounts. For example, under the allowed alternative method of IAS 16, property, plant and equipment can be adjusted to

fair value. In such a case, no further adjustment would be warranted, assuming that the adjustment to fair value was made as of the latest date of the statement of financial position. If the latest revaluation was as of an earlier date, the carrying amounts should be further adjusted to compensate for changes in the general price level from that date to the date of the statement of financial position, using the indexing technique noted above.

5. Consistent with the established principles of historical cost accounting, if the restated amounts of non-monetary assets exceed the recoverable amounts, these must be reduced appropriately. This can easily occur, since (as discussed earlier in this chapter) specific prices of goods will vary by differing amounts, even in a hyper-inflationary environment, and in fact some may decline in terms of current cost even in such cases, particularly when technological change occurs rapidly. Since the application of price level accounting, whether for ordinary inflation or for hyper-inflation, does not imply an abandonment of historical costing, being a mere translation into more timely and relevant purchasing power units, the rules of that mode of financial reporting still apply. Generally accepted accounting principles require that assets not be stated at amounts in excess of realizable amounts, and this constraint applies even when price level adjustments are reflected.
6. Equity accounts must also be restated to compensate for changing prices. Paid-in capital accounts are indexed by reference to the dates when the capital was contributed, which are usually a discrete number of identifiable transactions over the life of the entity. Revaluation accounts, if any, are eliminated entirely, as these will be subsumed in restated retained earnings. The retained earnings account itself is the most complex to analyse and in practice is often treated as a balancing figure after all other statement of financial position accounts have been restated. However, it is possible to compute the adjustment to this account directly, and that is the recommended course of action, lest other errors go undetected. To adjust retained earnings, each year's earnings should be adjusted by a ratio of indices, the numerator being the general price level as of the date of the statement of financial position, and the denominator being the price level as of the end of the year for which the earnings were reported. Reductions of retained earnings for dividends paid should be adjusted similarly.
7. IAS 29 addresses a few other special problem areas. For example, the standard notes that borrowing costs typically already reflect the impact of inflation (more accurately, interest rates reflect inflationary expectations), and thus it would represent a form of double counting to fully index capital asset costs for price level changes when part of the cost of the asset was capitalized interest, as defined in IAS 23 as an allowed alternative method (which under revised IAS 23, *Borrowing Costs*, effective 2009, is the only permitted method). As a practical matter, interest costs are often not a material component of recorded asset amounts, and the inflation-related component would only be a fraction of interest costs capitalized. However, the general rule is to delete that fraction of the capitalized borrowing costs which represents inflationary compensation, since the entire cost of the asset will be indexed to current purchasing units.

To restate the current period's statement of comprehensive income, a reasonably accurate result can be obtained if revenue and expense accounts are multiplied by the ratio of end-of-period prices to average prices for the period. Where price changes were not



relatively constant throughout the period, or when transactions did not occur ratably, as when there was a distinct seasonal pattern to sales activity, a more precise measurement effort might be needed. This can be particularly important when a devaluation of the currency took place during the year.

While IAS 29 addresses the statement of cash flows only perfunctorily (its issuance was prior to the revision of IAS 7), this financial statement must also be modified to report all items in terms of year-end purchasing power units. For example, changes in working capital accounts, used to convert net income into cash flow from operating activities, will be altered to reflect the real (i.e., inflation-adjusted) changes.

To illustrate, if beginning accounts receivable were €500,000 and ending receivables were €650,000, but prices rose by 40% during the year, the apparent €150,000 increase in receivables (which would be a use of cash) is really a €50,000 decrease [ $(€500,000 \times 1.4 = €700,000) - €650,000$ ], which in cash flow terms is a source of cash. Other items must be handled similarly. Investing and financing activities should be adjusted on an item-by-item basis, since these are normally discrete events that do not occur ratably throughout the year.

In addition to the foregoing, the adjusted statement of comprehensive income will report a gain or loss on net monetary items held. As an approximation, this will be computed by applying the change in general prices for the year to the average net monetary assets (or liabilities) outstanding during the year. If net monetary items changed materially at one or more times during the year, a more detailed computation would be warranted. In the statement of comprehensive income, the gain or loss on net monetary items should be associated with the adjustment relating to items that are linked to price level changes (indexed debt, etc.) as well as with interest income and expense and foreign exchange adjustments, since theoretically at least, all these items contain a component that reflects inflationary behaviour.

### **Restating Current Cost Financial Statements under Hyperinflation Conditions**

If the financial reporting system is based on current costing (as described earlier in the chapter), the process used to adjust the statement of financial position can be summarized as follows:

1. Monetary assets and liabilities are already presented in units of year-end purchasing power and receive no further adjustment. (See the appendix for a categorization of different assets and liabilities as to their status as monetary or non-monetary.)
2. Monetary assets and liabilities that are linked to price changes, such as indexed debt securities, are adjusted according to the terms of the contractual arrangement. This does not change the characterization of these items as monetary, but it does serve to reduce or even eliminate the purchasing power gain or loss that would have otherwise been experienced as a result of holding these items during periods of changing general prices.
3. Non-monetary items are already stated at year-end current values or replacement costs and need no further adjustments. Issues related to recoverable amounts and other complications associated with price level adjusted historical costs should not normally arise.
4. Equity accounts must also be restated to compensate for changing prices. Paid-in capital accounts are indexed by reference to the dates when the capital was contributed, which are usually a discrete number of identifiable transactions over the life of the entity. Revaluation accounts are eliminated entirely, as these will be subsumed in restated retained earnings. The retained earnings account itself will typically be a

“balancing account” under this scenario, since detailed analysis would be very difficult, although certainly not impossible, to accomplish.

The current cost statement of comprehensive income, absent the price level component, will reflect transactions at current costs as of the transaction dates. For example, cost of sales will be comprised of the costs as of each transaction date (usually approximated on an average basis). To report these as of the date of the statement of financial position, these costs will have to be further inflated to year-end purchasing power units, by means of the ratio of general price level indices, as suggested above.

In addition to the foregoing, the adjusted statement of comprehensive income will report a gain or loss on net monetary items held. This will be similar to that discussed under the historical cost reporting above. However, current cost statements of comprehensive income, if prepared, already will include the net gain or loss on monetary items held, which need not be computed again.

To the extent that restated earnings differ from earnings on which income taxes are computed, there will be a need to provide more or less tax accrual, which will be a deferred tax obligation or asset, depending on the circumstances.

### **Comparative Financial Statements**

Consistent with the underlying concept of reporting in hyperinflationary economies, all prior-year financial statement amounts must be updated to purchasing power units as of the most recent date of the statement of financial position. This will be a relatively simple process of applying a ratio of indices of the current year-end price level to the year earlier price level.

### **Other Disclosure Issues**

IAS 29 requires that when the standard is applied, the fact that hyperinflation adjustments have been made be noted. Furthermore, the underlying basis of accounting, historical cost or current cost, should be stipulated, as should the price level index that was utilized in making the adjustments.

### **Economies which Cease Being Hyperinflationary**

When application of IAS 29 is discontinued, the amounts reported in the last statement of financial position that had been adjusted become, effectively, the new cost basis. That is, previously applied adjustments are not reversed, since an end to a period of hyperinflation generally means only that prices have reached a plateau, not that they have deflated to earlier levels.

### **Guidance on Applying the Restatement Approach**

IFRIC issued an Interpretation of IAS 29 (IFRIC 7, *Applying the Restatement Approach*) that addresses the matter of differentiating between monetary and non-monetary items. IAS 29 requires that when the reporting entity identifies the existence of hyperinflation in the economy of its functional currency, it must restate its financial statements for the effects of inflation. The restatement approach distinguishes between monetary and non-monetary items, but in practice it has been noted there is uncertainty about how to restate the financial statements for the first time, particularly with regard to deferred tax balances, and concerning comparative information for prior periods. IFRIC 7 addresses these matters.

Under IFRIC 7, it is required that, in the first year that an entity identifies the existence of hyperinflation, it would start applying IAS 29 as if it had always applied that standard—

that is, as if the economy had always been hyperinflationary. Therefore, it must recreate an opening statement of financial position at the beginning of the earliest annual accounting period presented in the restated financial statements, for the first year it applies IAS 29.

The implication of this Interpretation is that restatements of non-monetary items that are carried at historical cost are effected as of the dates of first recognition (e.g., acquisition). The restatements cannot be effected merely from the opening date of the statement of financial position (which would commonly be at the beginning of the comparative financial statement year). For example, if the year-end 2013 statement of financial position is the first one under IAS 29, with two-year comparative reporting employed, but various plant assets acquired, say, in 2005, the application of IFRIC 7 would require restatements for price level changes from 2005 to year-end 2012.

Non-monetary assets that are not reported at historical costs (e.g., plant assets revalued for IFRS-basis financial reporting, per IAS 16) require a different mode of adjustment. In this situation, the restatements are applied only for the period of time elapsed since the latest revaluation dates (which should, per IAS 16, be recent dates in most instances). For example, if revaluation was performed at year-end 2010, then only the period from year-end 2010 to year-end 2012 would be subject to adjustment, as the year-end 2010 revaluation already served to address hyperinflation occurring to that date.

IFRIC 7 provides that if detailed records of the acquisition dates for items of property, plant and equipment are not available or are not capable of estimation, the reporting entity should use an independent professional assessment of the fair value of the items as the basis for restatement. Likewise, if a general price index is not available, it may be necessary to use an estimate based on the changes in the exchange rate between the functional currency and a relatively stable foreign currency, for example, when the entity restates its financial statements.

IFRIC 7 also provides specific guidance on the difficult topic of deferred tax balances in the *opening* statement of financial position of the entity subject to IAS 29 restatement. A two-step computational procedure is required to effect the restatement of deferred tax assets and liabilities. First, deferred tax items are remeasured in accordance with IAS 12, *after* having restated the nominal carrying amounts of all other non-monetary items in the opening statement of financial position as of that (opening statement of financial position) date. Second, the remeasured deferred tax assets and/or liabilities are restated for hyperinflation's effects from the opening date of the statement of financial position to the reporting date (the most recent date of the statement of financial position).

## US GAAP COMPARISON

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US GAAP does not generally permit inflation-adjusted financial statements. However, under US GAAP entities under hyperinflation conditions are deemed to use a functional currency of a highly inflationary economy if the cumulative inflation rate for three years exceeds 100%. No such bright-line exists under IFRS to identify hyperinflation. A 100% cumulative inflation rate over three years is only an indicator that must be considered.

Under US GAAP, subsidiaries (both consolidated or equity-method accounted) that use highly inflationary currencies must substitute the hyperinflation currency with a reporting currency. Accordingly, remeasurement effects from the transaction currency into the reporting currency are recognized in profit and loss. If the currency of a subsidiary ceases to be highly inflationary, the reporting currency at the date of change shall be translated into the local currency at current exchange rates.

**APPENDIX: MONETARY VS. NON-MONETARY ITEMS**

<u>Item</u>	<u>Monetary</u>	<u>Non-monetary</u>	<u>Requires analysis</u>
Cash on hand, demand deposits and time deposits	x		
Foreign currency and claims to foreign currency	x		
Securities			
Common stock (passive investment)		x	
Preferred stock (convertible or participating) and convertible bonds			x
Other preferred stock or bonds	x		
Accounts and notes receivable and allowance for doubtful accounts	x		
Mortgage loan receivables	x		
Inventories		x	
Loans made to employees	x		
Prepaid expenses			x
Long-term receivables	x		
Refundable deposits	x		
Advances to unconsolidated subsidiaries	x		
Equity in unconsolidated subsidiaries		x	
Pension and other funds			x
Property, plant and equipment and accumulated depreciation		x	
Cash surrender value of life insurance	x		
Purchase commitments (portion paid on fixed-price contracts)		x	
Advances to suppliers (not on fixed-price contracts)	x		
Deferred income tax charges	x		
Patents, trademarks, goodwill and other intangible assets		x	
Deferred life insurance policy acquisition costs	x		
Deferred property and casualty insurance policy acquisition costs		x	
Accounts payable and accrued expenses	x		
Accrued vacation pay			x
Cash dividends payable	x		
Obligations payable in foreign currency	x		
Sales commitments (portion collected on fixed-price contracts)		x	
Advances from customers (not on fixed-price contracts)	x		
Accrued losses on purchase commitments	x		
Deferred revenue			x
Refundable deposits	x		
Bonds payable, other long-term debt and related discount or premium	x		
Accrued pension obligations			x
Obligations under product warranties		x	
Deferred income tax obligations	x		

Deferred investment tax credits		x
Life or property and casualty insurance policy reserves	x	
Unearned insurance premiums		x
Deposit liabilities of financial institutions	x	

a full retrospective application of IFRS, which override the transitional provisions included in other IFRS. These exceptions and exemptions cover primarily two types of situations: (1) those requiring judgements by management about past conditions after the outcome of a particular situation is already known, and (2) those in which the cost of full retrospective application of IFRS would exceed the potential benefit to investors and other users of the financial statements. In addition, the standard specifies certain disclosure requirements.

IFRS 1 provides guidance that all companies must follow on initial adoption of IFRS. Although IFRS is considered a principles-based framework, the provisions of IFRS 1 are rules-based and must be followed as written. The standard is quite complex and companies in transition to IFRS must carefully analyse it in order to determine the most appropriate accounting treatment and take advantage of an opportunity to reassess all financial reporting.

#### Sources of IFRS

##### IFRS 1

*The Conceptual Framework for Financial Reporting*

## DEFINITIONS OF TERMS

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**Date of transition to IFRS.** This refers to the beginning of the earliest period for which an entity presents full comparative information under IFRS in its “first IFRS financial statements” (defined below).

**Deemed cost.** An amount substituted for “cost” or “depreciated cost” at a given date. In subsequent periods, this value is used as the basis for depreciation or amortization.

**Fair value.** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s-length transaction.

**First IFRS financial statements.** The first annual financial statements in which an entity adopts IFRS by making an explicit and unreserved statement of compliance with IFRS.

**First IFRS reporting period.** The latest reporting period covered by an entity’s first IFRS financial statements that contains an explicit and unreserved statement of compliance with IFRS.

**First-time adopter (of IFRS).** An entity is referred to as a first-time adopter in the period in which it presents its first IFRS financial statements.

**International Financial Reporting Standards (IFRS).** The standards issued by the International Accounting Standards Board (IASB). More generally, the term connotes the currently outstanding standards (IFRS), the interpretations issued by the IFRS Interpretations Committee (IFRIC), as well as all still-effective previous standards (IAS) issued by the predecessor International Accounting Standards Committee (IASC), and the interpretations issued by the IASC’s Standing Interpretations Committee (SIC).

**Opening IFRS statement of financial position.** The statement of financial position prepared in accordance with the requirements of IFRS 1 as of the “date of transition to IFRS.” IFRS 1 requires that a first-time adopter *prepare* and *present* an opening statement of financial position. Thus, this statement is *published* along with the “first IFRS financial statements.”

**Previous GAAP.** This refers to the basis of accounting (e.g., national standards) a first-time adopter used immediately prior to IFRS adoption.

**Reporting date.** The end of the latest period covered by financial statements or by an interim financial report.

## FIRST-TIME ADOPTION GUIDANCE

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### Objective and Scope of IFRS 1

IFRS 1 applies to an entity that presents its *first IFRS financial statements*. It specifies the requirements that an entity must follow when it first adopts IFRS as the basis for preparing its general-purpose financial statements. IFRS 1 refers to these entities as *first-time adopters*.

The objective of this standard is to ensure that an entity's first IFRS financial statements, including interim financial reports, present high-quality information that:

1. Is transparent and comparable over all periods presented;
2. Provides a suitable starting point for accounting in accordance with IFRS; and
3. Can be prepared at a cost that does not exceed the benefits accruing.

First-time IFRS adopters' financial statements should be comparable over time and between entities applying IFRS for the first time, as well as those already applying IFRS.

Per IFRS 1, an entity must apply the standard in its first IFRS financial statements and in *each interim financial report* it presents under IAS 34, *Interim Financial Reporting*, for a part of the period covered by its first IFRS financial statements. For example, if 20XX is the first annual period for which IFRS financial statements are being prepared, the quarterly or semiannual statements for 20XX, if presented, must also comply with IFRS.

According to the standard, an entity's first IFRS financial statements refer to the first annual financial statements in which the entity adopts IFRS by making an *explicit and unreserved statement* (in the financial statements) of compliance with IFRS (with *all IFRS!*).

IFRS 1 has been amended, per the Annual Improvements 2009–2011 Cycle published in May 2012, to clarify that where an entity in a previous period fully complied with IFRS, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with IFRS, and in the current period makes an explicit and unreserved statement of compliance with IFRS, has the choice of either applying IFRS 1 (in full); or to retrospectively apply IFRS in accordance with the provision of IAS 8, *Accounting Policies, Changes in Estimates and Errors* (application of this is discussed in more detail in Chapter 7). This amendment specifies some additional disclosures that are required and is effective for annual periods beginning on January 1, 2013, and early adoption is allowed.

In the amendments of the *Annual Improvements to IFRSs 2011–2013 Cycle* in December 2013 further amendments were made relating to the meaning of effective IFRSs. The amendments further clarify that an entity, in its first IFRS financial statements, has the choice between applying an existing and currently effective IFRS or applying early a new or revised IFRS that is not yet mandatorily effective, provided that the new or revised IFRS permits early application. An entity is required to apply the same version of the IFRS throughout the periods covered by those first IFRS financial statements. These amendments are applicable for annual periods beginning on or after July 1, 2014. Early adoption is however possible and entities are permitted to early adopt any individual amendment within the cycle without early adopting all other amendments.

IFRS-compliant financial statements presented in the current year would qualify as first IFRS financial statements if the reporting entity presented its most recent previous financial statements:

- Under national GAAP or standards that were inconsistent with IFRS in all respects;
- In conformity with IFRS in all respects, but without an explicit and unreserved statement to that effect;

- With an explicit statement that the financial statements complied with certain IFRS, but not with all applicable standards;
- Under national GAAP or standards that differ from IFRS but using some individual IFRS to account for items which were not addressed by its national GAAP or other standards;
- Under national GAAP or standards, but with a reconciliation of selected items to amounts determined under IFRS.

Other examples of situations where an entity's current year's financial statements would qualify as its first IFRS financial statements are when:

- The entity prepared financial statements in the previous period under IFRS but the financial statements had been identified as being "for internal use only" and had not been made available to the entity's owners or any other external users;
- The entity presented IFRS-compliant financial reporting in the previous period under IFRS for consolidation purposes without preparing a complete set of financial statements as mandated by IAS 1, *Presentation of Financial Statements*; and
- The entity did not present financial statements for the previous periods at all.

#### Example to illustrate the implications of the standard

Excellent Inc., incorporated in Mysteryland, is a progressive multinational corporation that has always presented its financial statements under the national GAAP of the country of incorporation, with additional disclosures made in its footnotes. The supplementary data included value-added statements and a reconciliation of major items on its statement of financial position to International Financial Reporting Standards (IFRS). Excellent Inc. has significant borrowings from international financial institutions, and these have certain restrictive financial covenants—such as a defined upper limit on the ratio of external debt to equity, and minimum annual return on investments. In order to monitor compliance with these covenants, Excellent Inc. also prepared a separate set of financial statements in accordance with IFRS, but these were never made available to the international financial institutions or to the shareholders of Excellent Inc.

With the growing global acceptance that IFRS had been receiving in recent years, the finance minister of Mysteryland attempted to have the country adopt IFRS as its national GAAP, but this was vetoed by the nation's accounting standard setters. Mysteryland's accession to membership in the WTO is being planned for 20XX-1, and the country is taking steps to gain recognition as a global economic player. Mysteryland was invited to participate in the World Economic Forum, and to publicize his country's commitment to globalization, the finance minister announced at this event that his country would adopt IFRS as its national GAAP beginning in 20XX. This announcement was subsequently ratified by Mysteryland's parliament (and later by its national standard-setting body) and thus it was publicly announced that IFRS would be adopted as the country's national GAAP from 20XX.

Excellent Inc. had always presented its financial statements under its national GAAP but had also voluntarily provided a reconciliation of major items on its statement of financial position to IFRS in its footnotes, and "for internal purposes" had also prepared a separate set of financial statements under IFRS. Despite these previous overtures towards IFRS compliance, in the year 20XX—when Excellent Inc. moves to IFRS as its national GAAP and presents its financial statements to the outside world under IFRS, with an explicit and unreserved statement that these financial statements comply with IFRS—it will nonetheless be considered a first-time adopter and will have to comply with the requirements of IFRS 1.

In cases when the reporting entity's financial statements in the previous year contained an explicit and unreserved statement of compliance with IFRS, but in fact did not fully



comply with all accounting policies under IFRS, such an entity would *not* be considered a first-time adopter for the purposes of IFRS 1. The disclosed or undisclosed departures from IFRS in previous years' financial statements of this entity would be treated as an "error" under IFRS 1, which warrants correction made in the manner prescribed by IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. In addition, an entity making changes in accounting policies as a result of specific transitional requirements in other IFRS is also not considered a first-time adopter.

IFRS 1 identifies three situations in which IFRS 1 would *not* apply. These exceptions include, for example, when an entity:

1. Stops presenting its financial statements under national requirements (i.e., its national GAAP) along with another set of financial statements that contained an explicit or unreserved statement of compliance with IFRS;
2. Presented its financial statements in the previous year under national requirements (its national GAAP) and those financial statements contained (improperly) an explicit and unreserved statement of IFRS compliance; or
3. Presented its financial statements in the previous year that contained an explicit and unreserved statement of compliance with IFRS, and its auditors qualified their report on those financial statements.

### Key Dates

In transition to IFRS, two important dates that must be clearly determined are the first IFRS *reporting date* and *transition date*. "Reporting date" for an entity's first IFRS financial statements refers to the end of the latest period covered by the annual financial statements, or interim financial statements, if any, that the entity presents under IAS 34 for the period covered by its first IFRS financial statements. This is illustrated in the following examples:

#### Examples to illustrate the reporting date

**Example 1:** Xodus Inc. presents its first annual financial statements under IFRS for the calendar year 20XX, which include an explicit and unreserved statement of compliance with IFRS. It also presents full comparative financial information for the calendar year 20XX-1. In this case, the latest period covered by these annual financial statements would end on December 31, 20XX, and the *reporting date* for the purposes of IFRS 1 is December 31, 20XX (presuming the entity does not present financial statements under IAS 34 for interim periods within calendar year 20XX).

**Example 2:** Similarly, if Xodus Inc. decides to present its first IFRS interim financial statements in accordance with IAS 34 for the six months ended June 30, 20XX, in addition to the first IFRS annual financial statements for the year ended December 31, 20XX, the *reporting date* would be June 30, 20XX (and not December 31, 20XX).

"Transition date" refers to the beginning of the earliest period for which an entity presents full comparative information under IFRS as part of its first IFRS financial statements. Thus the date of transition to IFRS depends on two factors: the date of adoption of IFRS; and the number of years of comparative information that the entity decides to present along with the financial information of the year of adoption. In accordance with IFRS 1, at least one year of comparative information is required. The "first IFRS reporting period" is the latest reporting period covered by an entity's first IFRS financial statements.

The financial reporting requirements under IFRS 1 are presented below. Assume that Adaptability, Inc. decides to implement IFRS in 20XX and to present comparative

information for one year only. The end of Adaptability's first IFRS reporting period is December 31, 20XX. The last reporting period under previous GAAP is 20XX-2. The example below illustrates reporting requirements under IFRS 1 applicable to this entity.

#### Example of IFRS 1 reporting requirements

Date of transition	Reporting date		
I-----I-----I-----I			
1/1/20XX-1	12/31/20XX-1	03/31/20XX	12/31/20XX

- Adaptability, Inc. must prepare and present an opening IFRS statement of financial position at the date of transition to IFRS, that is the beginning of business on January 1, 20XX-1 (or, equivalently, close of business on December 31, 20XX-2). Its last reporting period under “previous GAAP” is 20XX-2 and end of comparative period is on December 31, 20XX-1.
- Adaptability, Inc. will produce its first IFRS financial statements for the annual period ending December 31, 20XX. Its first IFRS reporting period is 20XX.
- Adaptability, Inc. will prepare and present its statement of financial position for December 31, 20XX (including comparative amounts for December 31, 20XX-1), statement of comprehensive income, statement of changes in equity and statement of cash flows for the year ending December 31, 20XX (including comparative amounts for 20XX-1) and disclosures (including comparative amounts for 20XX-1).

Adaptability, Inc. has quarterly reporting requirements; the entity will comply with IAS 34 and present the first IFRS-compliant interim report—the March 31, 20XX quarterly report. Consequently, the first IFRS reporting date is March 31, 20XX.

If Adaptability, Inc. would be required (or choose) to present two years of comparative information under IFRS, the transition date would be January 1, 20XX-2.

### Steps in Transition to IFRS

Transition to IFRS involves the following steps:

- Selection of accounting policies that comply with IFRSs effective at the reporting date.
- Preparation of an opening IFRS statement of financial position at the date of transition to IFRS as the starting point for subsequent accounting under IFRS.
  - *Recognize* all assets and liabilities whose recognition is required under IFRS;
  - *Derecognize* items as assets or liabilities if IFRS does not permit such recognition;
  - *Reclassify* items in the financial statements in accordance with IFRS; and
  - *Measure* all recognized assets and liabilities according to principles set forth in IFRS.
- Presentation and disclosure in an entity's first IFRS financial statements and interim financial reports.

### Selection of Accounting Policies

IFRS 1 stipulates that an entity should use the same accounting policies throughout all periods presented in its first IFRS financial statements, and also in its opening IFRS statement of financial position. Furthermore, the standard requires that those accounting policies must comply with each IFRS effective at the “reporting date” (as explained before) for its first IFRS financial statements, with certain exceptions. It requires full retrospective application of all IFRS effective at the reporting date for an entity's first IFRS financial

statements, except under certain defined circumstances wherein the entity is prohibited by IFRS from applying IFRS retrospectively (mandatory exceptions) or it may elect to use one or more exemptions from some requirements of other IFRS (optional exemptions). Both concepts are discussed later in this chapter.

If a new IFRS has been issued on the reporting date, but application is not yet mandatory, although reporting entities have been encouraged to apply it before the effective date, the first-time adopter is permitted, but not required, to apply it as well. As stated before, an entity's first reporting date under IFRS refers to the end of the latest period covered by the first annual financial statements in accordance with IFRS, or interim financial statements, if any, that the entity presents under IAS 34. For example, if an entity's first IFRS reporting date is December 31, 20XX, consequently:

- First IFRS financial statements must comply with IFRS in effect at December 31, 20XX; and
- Opening statement of financial position at January 1, 20XX-1, and comparative information presented for 20XX-1, must comply with IFRS effective at December 31, 20XX (at the end of the first IFRS reporting period).

On first-time adoption of IFRS, the first most important step that an entity has to take is the selection of accounting policies that comply with IFRS. Management must select initial IFRS accounting policies based on relevance and reliability as these choices will affect the company's financial reporting for years to come. While many accounting policy choices will simply reflect relevant circumstances (e.g., method of depreciation, percentage of completion vs. completed contract accounting), other choices will not depend on circumstances but result from IFRS flexibility (e.g., options for recognizing actuarial gains and losses, or option to designate non-trading instruments as available-for-sale).

The several areas where a choice of accounting policies under IFRS exists include:

- IFRS 1—Optional exemptions from the full retrospective application of IFRS for some types of transactions on first-time IFRS adoption (see optional exemptions from other IFRS);
- IFRS 3—In acquisitions of less than 100%, option to measure non-controlling interest at fair value or proportionate share of the acquiree's identifiable net assets (this choice will result in recognizing 100% of goodwill or only the parent's share of goodwill);
- IFRS 4—Remeasure insurance liabilities to fair value during each accounting period;
- IAS 1—
  - a. Present one statement of comprehensive income or separate income statement and comprehensive income statement;
  - b. Presentation of expenses in the income statement by nature or by function;
- IAS 2—
  - a. Value inventories at FIFO or weighted-average;
  - b. Measure certain inventories, for example agricultural produce, minerals and commodities, at net realizable value rather than cost;
- IAS 7—
  - a. Direct or indirect method for presenting operating cash flows;
  - b. Classify interest and dividends as operating, investing or financing;

- IAS 16—Measure property, plant and equipment using the cost-depreciation model or the revaluation through equity model;
- IAS 19—Many options available for recognizing actuarial gains and losses (immediately in profit or loss, immediately in equity, or different methods of spreading the cost);
- IAS 20—Various options of accounting for government grants;
- IAS 23—Borrowing costs;
- IAS 27, IAS 28, IAS 31—Cost or fair value model for investments in subsidiaries, associates and joint ventures in the *separate* financial statements;
- IAS 31—Equity method or proportionate consolidation for joint ventures;
- IAS 38—The cost-depreciation model or revaluation through equity model for intangible assets with quoted market prices;
- IAS 39—
  - a. Optional hedge accounting;
  - b. Option to designate individual financial assets and financial liabilities to be measured at fair value through P&L;
  - c. Option to designate non-trading instruments as available-for-sale;
  - d. Option to reclassify out of fair-value-through-profit or loss, and out of available-for-sale categories;
  - e. Option to adjust the carrying amount of a hedged item for gains and losses on the hedging instrument;
  - f. Option of trade date or settlement date accounting; and
  - g. Option to separate an embedded derivative or account for the entire contract at fair-value-through-profit or loss;
- IAS 40—
  - a. The cost-depreciation model or fair value model for investment property; and
  - b. Option to classify land use rights as investment property.

A first-time adopter is not allowed to apply different versions of IFRS that were effective at earlier periods. With the passage of time, IFRS have been revised or amended several times and in some instances the current version of IFRS is vastly different from the earlier versions that were either superseded or amended. IFRS 1 requires a first-time adopter to use the current version of IFRS (or future standards, if early adoption permitted), without considering the superseded versions. This obviates the need to identify varying iterations of the standards that would have guided the preparation of the entity's financial statements at each prior reporting date, which would have been a very time-consuming and problematic task. This means that the comparative financial statements accompanying the first IFRS-compliant reporting may differ—perhaps materially—from what would have been presented in those earlier periods had the entity commenced reporting consistent with IFRS at an earlier point in time. Entities can early adopt new standards if early adoption is permitted by the standards, but cannot apply standards that are not published at the first IFRS reporting period.

The IASB's original thinking was to grant the first-time adopter an option to elect application of IFRS *as if it had always applied IFRS* (i.e., from the entity's inception). However, to have actualized this, the first-time adopter would have had to consider the various iterations of IFRS that had historically existed over the period of time culminating

with its actual adoption of IFRS. Upon reflection, this would have created not merely great practical difficulties for preparers, but would have negatively impacted comparability among periods and across reporting entities. Thus IFRS 1, as promulgated, offers no such option.

The amendment to IFRS 1 as part of the 2010 *Improvement to IFRS* clarified that, if a first-time adopter changes its accounting policies or its use of the exemptions in IFRS 1 after it has published an interim financial report in accordance with IAS 34, *Interim Financial Reporting*, but before its first IFRS financial statements are issued, it should explain those changes and update the reconciliations between previous GAAP and IFRS. The requirements in IAS 8 do not apply to such changes.

### Opening IFRS Statement of Financial Position

A first-time adopter must prepare and present an opening IFRS statement of financial position at the date of transition to IFRS. This statement serves as the starting point for the entity's accounting under IFRS. Logically, preparation of an opening statement of financial position is a necessary step in order to accurately restate the first year's statements of comprehensive income, changes in equity and cash flows.

#### Example to illustrate the date of the opening statement of financial position

Adaptability, Inc. decided to adopt IFRS in its annual financial statements for the fiscal year ending December 31, 20XX, and to present comparative information for the year 20XX-1. Thus, the beginning of the earliest period for which the entity should present full comparative information under IFRS would be January 1, 20XX-1. Accordingly, the opening IFRS statement of financial position for purposes of compliance with IFRS 1 would be that as of the beginning of business on January 1, 20XX-1 (equivalent to the closing of business on December 31, 20XX-2).

Alternatively, if Adaptability, Inc. decided (or was required, e.g., by the stock listing authorities) to present two years of comparative information (i.e., for both 20XX-2 and 20XX-1), as well as for the current year 20XX, then the beginning of the earliest period for which the entity would present full comparative information would be January 1, 20XX-2 (equivalent to close of business on December 31, 20XX-3). Accordingly, the opening IFRS statement of financial position for purposes of compliance with IFRS 1 would be that as of January 1, 20XX-2, under these circumstances.

The opening statement of financial position, prepared at the transition date, must be based on standards applied at the end of the first reporting period. This implies that advance planning will be required for several items, including hedging, and that the opening statement of financial position cannot be finalized until the end of the first IFRS reporting period (reporting date).

#### Example to illustrate IFRS to be applied in the opening statement of financial position

ABC entity's first IFRS reporting period will end on December 31, 20XX, and its transition date is January 1, 20XX-1, since only one comparative period will be presented. In the first IFRS financial statements ABC will apply IFRS 7, as amended in 2010, in all periods presented in the first IFRS financial statements. The amendment in question clarifies the intended interaction between qualitative and quantitative disclosures of the nature and extent of risks arising from financial instruments and removed some disclosure items which were seen to be superfluous or misleading and was effective for all accounting periods beginning on or after January 1, 20XX-1.

In preparing the opening IFRS statement of financial position in transition from previous GAAP to IFRS, several adjustments to the financial statements are required. A

first-time IFRS adopter should apply the following (except in cases where IFRS 1 prohibits retrospective application or grants certain exemptions):

1. *Recognize* all assets and liabilities whose recognition is required under IFRS. It is expected that many companies will recognize additional assets and liabilities under IFRS reporting, when compared with the national GAAP formerly employed. Areas which may result in this effect include:
  - Defined benefit pension plans (IAS 19);
  - Deferred taxation (IAS 12);
  - Assets and liabilities under certain finance leases (IAS 17);
  - Provisions where there is a legal or constructive obligation (IAS 37);
  - Derivative financial instruments (IAS 39);
  - Internal development costs (IAS 38); and
  - Share-based payments (IFRS 2).
2. *Derecognize* items as assets or liabilities if IFRS does not permit such recognition. Some assets and liabilities recognized under an entity's previous (national) GAAP will have to be derecognized. For example:
  - Provisions where there is no legal or constructive obligation (e.g., general reserves, post-acquisition restructuring) (IAS 37);
  - Internally generated intangible assets (IAS 38); and
  - Deferred tax assets where recovery is not probable (IAS 12).
3. *Reclassify* items that are recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRS. Assets and liabilities that might be reclassified to conform to IFRS include:
  - Investments accounted for in accordance with IAS 39;
  - Certain financial instruments previously classified as equity;
  - Any assets and liabilities that have been offset where the criteria for offsetting in IFRS are not met—for example, the offset of an insurance recovery against a provision;
  - Non-current assets held-for-sale (IFRS 5); and
  - Non-controlling interest (IFRS 10).
4. *Measure* all recognized assets and liabilities according to principles set forth in IFRS. This remeasurement may be required when the accounting basis is the same but measured differently (e.g., cost basis under IFRS may not be the same as under US GAAP), when the basis is changed (e.g., from cost to fair value) or there are differences in the applicability of discounting (e.g., provisions or impairments). Assets and liabilities that might have to be measured differently include:
  - Receivables (IAS 18);
  - Inventory (IAS 2);
  - Employee benefit obligations (IAS 19);
  - Deferred taxation (IAS 12);
  - Financial instruments (IAS 39);
  - Provisions (IAS 37);

- Impairments of property, plant and equipment, and intangible assets (IAS 36);
- Assets held for disposal (IFRS 5); and
- Share-based payments (IFRS 2).

**Example to illustrate adjustments required to IFRS opening statement of financial position on transition**

ABC Inc. presented its most recent financial statements under the national GAAP through 20XX-1. It adopted IFRS from 20XX and is required to prepare an opening IFRS statement of financial position as at January 1, 20XX-1. In preparing the IFRS opening statement of financial position, ABC Inc. noted the following:

Under its previous GAAP, ABC Inc. sold certain financial receivables as well as trade receivables for the amount of \$250,000 to special-purpose entities (SPEs) that are not consolidated although they conduct activities on behalf of the Group. In addition, ABC Inc. was using the last-in first-out (LIFO) method to account for certain inventories, and, consequently, reported the carrying value of inventory reduced by \$150,000, as compared to the value under the FIFO method. Furthermore, it had not discounted, to present value, long-term provisions for warranty of \$100,000 although the effect of discounting would be material (\$10,000). Finally, all research and development costs of \$500,000 (of which total \$300,000 relates to research costs) for the invention of new products were expensed when incurred.

In order to prepare the opening IFRS statement of financial position at January 1, 20XX-1, ABC Inc. would need to make the following adjustments to its statement of financial position at December 31, 20XX-2, presented under its previous GAAP:

1. IFRS 10 requires ABC Inc. to consolidate a SPE where it is deemed to control it. Indicators of control include the SPE conducting activities on behalf of the Group and/or the Group holding the majority of the risks and rewards of the SPE. Thus, SPEs should be consolidated and \$250,000 of receivables is recognized under IFRS;
2. IAS 2 prohibits the use of LIFO. Consequently, the Group adopted the FIFO method and had to increase inventory by \$150,000 under IFRS;
3. IAS 37 states that long-term provisions must be discounted to their present value if the effect from discounting is material. As a result, the Group adjusted the amount of provisions for warranty by \$10,000, the effect from discounting;
4. IAS 38 allows that development costs are capitalized as intangible assets if the technical and economic feasibility of a project can be demonstrated. Thus, \$200,000 incurred on development costs should be capitalized as an intangible asset under IFRS.

### **Mandatory Exceptions to the Retrospective Application of Other IFRS**

IFRS 1 *prohibits* retrospective application of some aspects of other IFRS when a judgement would have been required about the past and the outcome is known on first-time adoption. For example, practical implementation difficulties could arise from the retrospective application of aspects of IAS 39 or could lead to selective designation of some hedges to report a particular result. Mandatory exceptions relate to estimates, derecognition of non-derivative financial assets and non-derivative financial liabilities, hedge accounting and non-controlling interests.

#### ***Estimates***

An entity's estimates under IFRS at the date of transition to IFRS should be consistent with estimates made for the same date under its previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective

evidence that those estimates were in error, as that term is defined under IFRS. Especially, such estimates as those of market prices, interest rates or foreign exchange rates should reflect market conditions at the date of transition to IFRS. Revisions based on information developed after the transition date should only be recognized as income or expense (reflected in results of operations) in the period when the entity made the revision, and may not be “pushed back” to the opening IFRS statement of financial position prepared at the transition date at which, historically, the new information had not been known. Any information an entity receives after the date of transition to IFRS about estimates it made under previous GAAP should be treated as a *non-adjusting* event after the date of the statement of financial position, and accorded the treatment prescribed by IAS 10, *Events after the Reporting Period*.

**Example to illustrate mandatory exception applicable to estimates**

ABC Inc. recognized a provision for legal claims of \$800 in accordance with previous GAAP at the date of transition to IFRS on January 1, 20XX-1. The settlement amount is \$900, which is known on June 11, 20XX, and requires the revision of this estimate. The entity should not reflect that new information in its opening IFRS statement of financial position (unless the estimate needs adjustment for any differences in accounting policies or there is objective evidence that the estimate was in error, in accordance with IAS 8). Instead, ABC Inc. will reflect that new information as an expense of \$100 in profit or loss for the year ended December 31, 20XX.

***Derecognition of non-derivative financial assets and non-derivative financial liabilities (IAS 39)***

If a first-time adopter derecognized non-derivative financial assets or non-derivative financial liabilities under its previous GAAP, it should not recognize those assets and liabilities under IFRS, unless they qualify for recognition as a result of a later transaction or event. However, an entity may apply the derecognition requirements retrospectively, from a date of the entity’s choice, if the information needed to apply IAS 39 to derecognized items as a result of past transactions was obtained at the time of initially accounting for those transactions.

A first-time adopter should recognize all derivatives and other interests retained after derecognition and still existing, and consolidate all special-purpose entities (SPEs) that it controls at the date of transition to IFRS (even if the SPE existed before the date of transition to IFRS or holds financial assets or financial liabilities that were derecognized under previous GAAP).

***Hedge accounting (IAS 39)***

A first-time adopter is required, at the date of transition to IFRS, to measure all derivatives at fair value and eliminate all deferred losses and gains on derivatives that were reported under its previous GAAP. However, a first-time adopter is not permitted to reflect a hedging relationship in its opening IFRS statement of financial position if it does not qualify for hedge accounting under IAS 39. But if an entity designated a net position as a hedged item under its previous GAAP, it may designate an individual item within that net position as a hedged item under IFRS, provided it does so prior to the date of transition to IFRS. Transitional provisions of IAS 39 apply to hedging relationships of a first-time adopter at the date of transition to IFRS.



**Non-controlling interests (IFRS 3)**

A first-time adopter should apply the following requirements prospectively from the date of transition to IFRS:

- Attribution of total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;
- Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
- Accounting for a loss of control over a subsidiary, and the related requirements of IFRS 5.

**OPTIONAL EXEMPTIONS**

IFRS 1 allows a first-time adopter to elect to use one or more optional (voluntary) exemptions from the retrospective application of other IFRS. Optional exemptions from the retrospective application of other IFRS are granted on first-time adoption in specific areas where the cost of complying with the requirements of IFRS 1 would be likely to exceed the benefits to users of financial statements or where the retrospective application is impractical. A parent company and all of its subsidiaries must analyse these exemptions to determine which exemptions to apply and how to apply them, but it should be emphasized that the exemptions do not impact future accounting policy choices and cannot be applied by analogy to other items.

The application of these optional exemptions is explained in detail below. A first-time adopter of IFRS may elect to use exemptions from the general measurement and restatement principles in one or more of the following instances:

***Business combinations***

(IFRS 3, *Business Combinations*). IFRS 1 exempts the first-time adopter from mandatory retrospective application in the case of business combinations that occurred before the date of transition to IFRS. That is, requirements under IFRS 3 can be applied in accounting for combinations that occurred before the transition date under IFRS, but this *need not be done*. Thus, under IFRS 1, an entity may elect to use previous national GAAP accounting relating to such business combinations. The IASB provided this exemption because, if retrospective application of IFRS 3 had been made obligatory, it could have forced entities to estimate (or make educated guesses) about conditions that presumably prevailed at the respective dates of past business combinations. This would have been particularly challenging where data from past business combinations had not been preserved. The use of such estimates could have adversely affected the relevance and reliability of the financial statements, and was thus seen as a situation to be avoided.

In evaluating responses to the draft of its standard on first-time adoption of IFRS, the IASB concluded that notwithstanding the fact that restatement of past business combinations to conform with IFRS was conceptually preferable, a pragmatic assessment of cost versus benefit weighed in favour of *permitting* but *not requiring* such restatement. However, the IASB did place an important limitation on this election: if a first-time adopter having multiple acquisition transactions restates *any* business combination, it must restate *all* business combinations that took place subsequent to the date of that restated combination

transaction. First-time adopters thus cannot “cherry pick” among past business combinations to apply IFRS opportunistically to certain of them.

**Example to illustrate business combination exemption**

	Business Combination 1 selected for IFRS conversion	Business Combination 2	Transition date	
I-----I	I-----I	I-----I	I-----I	I-----I
1/1/20XX-1	6/6/20XX-1	3/31/20XX	12/31/20XX	12/31/20XX

For instance, if ABC Inc., a first-time adopter, did not seek this exemption, and instead opted to apply IFRS 3 retrospectively, and restated a major business combination that took place on June 6, 20XX-1, then, under this requirement of IFRS 1, ABC Inc. is required to restate business combinations that took place subsequent to the date of that major business combination to which it applied IFRS 3 retrospectively. Earlier combinations would *not* have to be restated.

If the entity employs the exemption under IFRS 1 and does not apply IFRS 3 retrospectively to a past business combination, it must observe these rules:

1. The first-time adopter should preserve the same classification (an *acquisition* or a *uniting of interests*) as was applied in its previous GAAP financial statements.
2. The first-time adopter should recognize all assets and liabilities at the date of transition to IFRS that were acquired or assumed in a past business combination, except:
  - a. Certain financial assets and financial liabilities that were derecognized under its previous GAAP; and
  - b. Assets (including goodwill) and liabilities that were not recognized in the acquirer’s consolidated statement of financial position under previous GAAP and also would not qualify for recognition under IFRS in the separate statement of financial position of the acquiree.

Any resulting change should be recognized by the first-time adopter in retained earnings (or another component of equity, if appropriate) unless the change results from the recognition of an intangible asset that was previously incorporated within goodwill.

3. The first-time adopter should derecognize (i.e., exclude) from its opening IFRS statement of financial position any item recognized under previous GAAP that does not qualify for recognition, either as an asset or liability, under IFRS. The resulting change from this derecognition should be accounted by the first-time adopter as follows: first, if the first-time adopter had classified a past business combination as an acquisition and recognized as an intangible asset an item that does not qualify for recognition as an asset under IAS 38, it should reclassify that item (and any related deferred tax and non-controlling interests) as part of goodwill (unless it deducted goodwill from equity, instead of presenting it as an asset, under its previous GAAP); and second, the first-time adopter should recognize all other resulting changes in retained earnings.
4. In cases where IFRS require subsequent measurement of some assets and liabilities on a basis other than original cost, such as fair value, the first-time adopter should measure these assets and liabilities on that basis in its opening IFRS statement of financial position, even if these assets and liabilities were acquired or assumed in a preceding business combination. Any resulting change in the carrying amount should be recognized by the first-time adopter in retained earnings (or another component of equity, if appropriate), instead of as an adjustment to goodwill.
5. Subsequent to the business combination, the carrying amount under previous GAAP of assets acquired and liabilities assumed in the business combination should be treated as their

*deemed cost* under IFRS at that date. If IFRS require a cost-based measurement of those assets and liabilities at a later date, deemed cost should be used instead (e.g., as the basis for cost-based depreciation or amortization from the date of the business combination).

6. If assets acquired or liabilities assumed were not recognized in a past business combination under the previous GAAP, the first-time adopter should recognize and measure them in its consolidated statement of financial position on the basis that IFRS would require in the separate statement of financial position of the acquiree.
7. The carrying amount of goodwill in the opening IFRS statement of financial position should be its carrying amount under previous GAAP at the date of transition to IFRS, after the following adjustments:
  - a. The carrying amount of goodwill should be increased due to a reclassification that would be needed for an intangible asset recognized under previous GAAP but which does not qualify as an intangible asset under IAS 38. Similarly, the carrying amount of goodwill should be decreased due to inclusion of an intangible asset as part of goodwill under previous GAAP but which requires separate recognition under IFRS.
  - b. If the purchase consideration of a past business combination was based on a contingency which was resolved prior to the date of transition to IFRS, and a reliable estimate of the adjustment relating to the contingency can be made and it is probable that a payment will be made, the first-time adopter should adjust the carrying amount of goodwill by that amount. Similarly, if a previously recognized contingency can no longer be measured reliably, or its payment is no longer probable, the first-time adopter should adjust the carrying amount of goodwill accordingly.
  - c. Whether or not there is evidence of impairment of goodwill, the first-time adopter should apply IAS 36 in testing goodwill for impairment, if any, and should recognize the resulting impairment loss in retained earnings (or, if so required by IAS 36, in revaluation surplus).

The impairment test should be based on conditions at the date of transition to IFRS.

8. No other adjustments are permitted by IFRS 1 to the carrying amount of goodwill at the date of transition to IFRS. The following adjustments would be prohibited:
  - a. Reducing goodwill to separately reflect in-process research and development acquired in that business combination;
  - b. Adjusting previous amortization of goodwill; or
  - c. Reversing adjustments to goodwill that IFRS 3 would not permit but which were appropriately made under previous GAAP.
9. If under its previous GAAP a first-time adopter did not consolidate a subsidiary acquired in a business combination (i.e., because the parent did not treat it as a subsidiary under previous GAAP), the first-time adopter should adjust the carrying amounts of the subsidiary's assets and liabilities to the amounts that IFRS would require in the subsidiary's separate statement of financial position. The deemed cost of goodwill would be equal to the difference at the date of transition to IFRS between the parent's interest in those adjusted carrying amounts and the cost in the parent's separate financial statements of its investment in the subsidiary.
10. The non-controlling interest should be adjusted to reflect its share of the adjustments to recognized assets and liabilities.

IFRS 1 states that these exemptions for past business combinations also apply to past acquisitions of investments in associates and in joint ventures. Furthermore, the date chosen for electing to apply IFRS 3 retrospectively to past business combinations applies equally to associates and joint ventures.

**Example to illustrate the effects of first time adoption of IFRS**

ABC Inc., a first-time adopter, has a transition date of January 1, 20XX. ABC acquired entity DEF on June 1, 20XX-1. Under previous GAAP, in accounting for this acquisition, ABC (1) did not separately recognize development costs of \$100 at 1/1/20XX; (2) recognized a general restructuring provision of \$200, which was 75% outstanding at 1/1/20XX; (3) did not recognize a deferred tax asset of \$50 resulting from temporary differences associated with assets acquired and liabilities assumed. In transition to IFRS, ABC elects not to restate previous business combinations.

At the date of transition, ABC has to make the following adjustments: (1) recognize development costs of \$100, with the adjustment taken to goodwill; (2) derecognize the general restructuring provision of \$200, with the adjustment recognized in retained earnings; (3) recognize a deferred tax asset of \$50, with the adjustment recognized in retained earnings.

In addition, the concept of “push-down accounting,” required under SEC guidance in special circumstances, does not exist in IFRS. It means that previous revaluations to fair value at acquisition made by subsidiaries in order to apply push-down accounting need to be reversed on transition to IFRS, but those revaluations can be used as deemed cost of property, plant and equipment, certain intangible assets, and investment property.

***Share-based payment transactions***

(IFRS 2, *Share-Based Payment*). On first-time IFRS adoption an entity is encouraged, but not required, to apply IFRS 2 to equity instruments that were granted on or before November 7, 2002. In addition, the adopter is also encouraged, but not required, to apply IFRS 2 to equity instruments that were granted after November 7, 2002, and vested before the later of (1) the date of transition to IFRS, and (2) January 1, 2005; and to liabilities arising from share-based payment transactions that were (1) settled before the date of transition to IFRS, or (2) settled before January 1, 2005. But the latter option can only be applied if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date.

Additionally, a first-time adopter is encouraged, but not required, to apply IFRS 2 to liabilities arising from share-based payment transactions that were (1) settled before the date of transition to IFRS, or (2) settled before January 1, 2005. The adopter is not required to present comparative information for liabilities presented under IFRS 2 for a period or date that is earlier than November 7, 2002.

***Insurance contracts***

(IFRS 4, *Insurance Contracts*.) A first-time adopter may apply the transitional provisions in IFRS 4. The standard restricts changes in accounting policies for insurance contracts, including those made by a first-time adopter.

***Deemed cost***

An entity may elect to measure an item of property, plant and equipment at fair value at the date of its transition to IFRS and use the fair value as its deemed cost at that date. In accordance with IFRS 1, “deemed cost” is an amount substituted for “cost” or “depreciated cost” at a given date, and this value is subsequently used as the basis for depreciation or amortization. A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment at, or before, the date of transition to IFRS as deemed

costs at the date of revaluation if the revaluation amount, when determined, was broadly comparable to either fair value or cost (or depreciated cost under IFRS adjusted for changes in general or specific price index).

These elections are equally available for investment property measured under the cost model and intangible assets that meet the recognition criteria and the criteria for revaluation (including the existence of an active market).

**Example to illustrate the effect of the deemed cost exemption**

ABC Inc., a first-time adopter, has a transition date of January 1, 20XX. ABC revalued buildings under previous GAAP and on the last revaluation date at 12/31/11, the buildings were valued at \$500. Depreciation of \$60 has been charged since the revaluation and the expected remaining useful life is 20 years. At 1/1/20XX ABC had a cumulative balance in the revaluation reserve of \$100. At the date of transition to IFRS, ABC elects the deemed cost exemption. ABC makes the following adjustments to its opening IFRS statement of financial position: (1) buildings are recognized at the deemed cost of \$500; (2) the revaluation reserve of \$100 is taken to retained earnings; (3) accumulated depreciation of \$6 must be recognized for the period 12/31/11 to 1/1/20XX [ $(500 - 60)/20 = 22$  annually;  $(22 \times 3 = 66) - 60 = 6$ ]

If a first-time adopter has established a deemed cost under previous GAAP for any of its assets or liabilities by measuring them at their fair values at a particular date because of the occurrence of an event such as privatization or an initial public offering (IPO), it is allowed to use such an event-driven fair value as deemed cost for IFRS at the date of that measurement. The May 2010 *Improvements to IFRS* amended IFRS 1 to clarify that a first-time adopter is also permitted to use an event-driven fair value as “deemed cost” at the measurement date for measurement events that occurred after the date of transition to IFRS but during the period covered by the first IFRS financial statements. Any resulting adjustment is recognized directly in equity at the measurement date.

First-time adopters must assess and evaluate available accounting options under IAS 16 and determine which options would be more advantageous going forward, when adopting IFRS. For example, the first IFRS financial statements must present property, plant and equipment as if the requirements of IAS 16 had always been applied. While the “component approach” to depreciation is allowed but rarely used under US GAAP, this approach is required under IFRS and may result in significant adjustments in conversion for US adopters discussed in detail in Chapter 9, Property, Plant and Equipment.

It is common in some countries to account for exploration and development costs for properties in development or production in cost centers that include all properties in a large geographical area (often referred to as “full cost accounting”). Since this approach is not allowed under IFRS, the process of remeasuring the assets on the first-time adoption of IFRS would likely be tedious and expensive. The amendments to IFRS 1, in effect for annual periods beginning on or after January 1, 2011, would allow an entity that used full cost accounting under its previous GAAP to measure exploration and evaluation assets, as well as oil and gas assets in the development or production phases, at the date of transition to IFRS, at the amount determined under the entity’s previous GAAP.

The amendments allow an entity that used such accounting under previous GAAP to elect to measure oil and gas assets at the date of transition on the following basis:

1. Exploration and evaluation assets at the amount determined under previous GAAP; and

2. Assets in the development or production phases at the amount determined for the cost center under previous GAAP. This amount is allocated pro rata to the underlying assets, using reserve volumes or reserve values as of that date.

To avoid the use of deemed costs resulting in an oil and gas asset being measured at more than its recoverable amount, the first-time adopter should test exploration and evaluation assets and assets in the development and production phases for impairment at the date of transition to IFRS in accordance with IFRS 6, *Exploration for and Evaluation of Mineral Resources*, or IAS 36, *Impairments of Assets*, and, if necessary, reduce the amount determined in accordance with (1) and (2). This paragraph considers only those oil and gas assets that are used in the exploration, evaluation, development or production of oil and gas.

In addition, in the May 2010 *Improvements to IFRS*, the IASB amended IFRS 1 to allow entities with rate-regulated activities that hold, or previously held, items of property, plant and equipment or intangible assets for use in such operations (and recognized separately as regulatory assets) that may not be eligible for capitalization under IFRS to recognize such items and to elect to use the previous GAAP carrying amount of such items as their deemed cost at the date of transition to IFRS. This exemption is available on an item-by-item basis, but entities are required to immediately (at the date of transition to IFRS) test for impairment in accordance with IAS 36 each item for which this exemption is used. (See discussion of rate-regulated activities in Chapter 32, Extractive Industries.)

### **Leases**

In accordance with IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, a first-time adopter may determine whether an arrangement existing at the date of transition to IFRS contains a lease on the basis of facts and circumstances existing at that date.

IFRS 1 exempts entities with existing leasing contracts that made, under previous GAAP, the same determination as that required by IFRIC 4, but that assessment was at a date other than that required by IFRIC 4, from reassessing the classification of those contracts when adopting IFRS.

### **Below market rate government loans**

In the amendment to IFRS 1 issued in March 2012, it was clarified that first-time adopters will not be required to recognize the corresponding benefit of a government loan at a below-market rate of interest, as a government grant. An entity may still elect to retrospectively apply the requirements in IAS 20 and IFRS 9 if the information needed to do so was obtained at the time of initially accounting for that loan. The amendment will give first-time adopters the same relief as existing preparers of IFRS financial statements.

### **Cumulative translation differences**

A first-time IFRS adopter has the option to reset to zero all cumulative translation differences arising on monetary items that are part of a company's net investment in foreign operations existing at the transition date. IAS 21 requires an entity to classify certain translation differences as a separate component of equity, and upon disposal of the foreign operation, to transfer the cumulative translation difference relating to the foreign operation to the statement of comprehensive income as part of the gain or loss on disposal.

Under IFRS 1, a first-time adopter is exempted from recognizing cumulative translation differences on foreign operations prior to the date of transition to IFRS. If it elects this

exemption, the cumulative translation adjustment for all foreign operations would be deemed to be zero and the gain or loss on subsequent disposal of any foreign operation should exclude translation differences that arose before the date of transition to IFRS, but would include all subsequent translation adjustments recognized in accordance with IAS 21.

A company on transition to IFRS may also need to change the functional currency of one or more subsidiaries under IAS 21, due to differences in existing guidance in this respect. This could possibly create the need to revalue property, plant and equipment on first-time adoption rather than restating non-monetary assets measured at historical cost, which could be onerous.

#### ***Investments in subsidiaries, jointly controlled entities, and associates***

In accordance with IAS 27 a company may value its investments in subsidiaries, jointly controlled entities and associates either at cost or in accordance with IAS 39. Under IFRS 1, a first-time adopter electing deemed cost to account for these investments may choose either fair value, determined in accordance with IAS 39, at the entity's date of transition to IFRS, or carrying amount under previous GAAP at that date.

#### ***Assets and liabilities of subsidiaries, associates and joint ventures***

IFRS 1 provides exemptions under two circumstances as follows:

1. If a subsidiary becomes a first-time adopter later than its parent, the subsidiary must, in its separate (stand-alone) financial statements, measure its assets and liabilities at either:
  - a. The carrying amounts that would be included in its parent's consolidated financial statements, based on its parent's date of transition to IFRS (if no adjustments were made for consolidation procedures and for the effect of the business combination in which the parent acquired the subsidiary); or
  - b. The carrying amounts required by the other provisions of IFRS 1, based on the subsidiary's date of transition to IFRS.

A similar choice can be made by associates or joint ventures that adopt IFRS later than the entity.

2. If a reporting entity (parent) becomes a first-time adopter after its subsidiary (or associate or joint venture) the entity is required, in its consolidated financial statements, to measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the separate (stand-alone) financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for effects of the business combination in which an entity acquired the subsidiary. In a similar manner, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

In cases where a subsidiary decided to elect different exemptions from those the parent selects for the preparation of consolidated financial statements, this may create permanent differences between the subsidiaries' and parents' books, requiring adjustments in consolidation. This exemption does not impact the requirement in IAS 1 that uniform accounting policies must be applied in the consolidated entities for all entities within a group.

### ***Compound financial instruments***

If an entity has issued a compound financial instrument, such as a convertible debenture, with characteristics of both debt and equity, IAS 32 requires that at inception, it should split and separate the liability component of the compound financial instrument from equity. If the liability portion no longer is outstanding at the date of adoption of IFRS, a retrospective and literal application of IAS 32 would require separating two portions of equity. The first portion, which is in retained earnings, represents the cumulative interest accreted on the liability component. The other portion represents the original equity component of the instrument, and would be in paid-in capital.

IFRS 1 exempts a first-time adopter from this split accounting if the former liability component is no longer outstanding at the date of transition to IFRS. This exemption can be significant to companies that routinely issue compound financial instruments.

### ***Designation of previously recognized financial instruments***

IFRS 1 permits a first-time adopter to designate a financial asset as available-for-sale and a financial instrument (provided it meets certain criteria) as a financial asset or financial liability at fair value through profit or loss, at the *date of transition* to IFRS. IAS 39 requires such designation to be made on *initial* recognition.

### ***Fair value measurement of financial assets or financial liabilities at initial recognition***

A first-time adopter may apply requirements of IAS 39 regarding (1) the best evidence of the fair value of a financial instrument at initial recognition, and (2) the subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses, prospectively to transactions entered into on or after the date of transition to IFRS.

### ***Decommissioning liabilities included in the cost of property, plant and equipment***

IFRS 1 provides that a first-time adopter need not comply with the requirements of IFRIC 1, *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, for changes in such liabilities that occurred before the date of transition to IFRS. Adjustments to liabilities on first-time IFRS adoption arise from events and transactions before the date of transition to IFRS and are generally recognized in retained earnings. For entities using this exemption, certain measurements and disclosures are required. If a first-time adopter uses these exemptions, it should:

1. Measure the liability at the date of transition in accordance with IAS 37;
2. Estimate the amount of the liability (that is within the scope of IFRIC 1) that would have been included in the cost of the related asset when the liability was first incurred, by discounting the liability to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period; and
3. Calculate the accumulated depreciation on that amount, as of the date of transition to IFRS, on the basis of the current estimate of the useful life of the asset, using the depreciation policy in accordance with IFRS.

In addition, an entity that uses the exemption in IFRS 1 to value at deemed cost determined under previous GAAP oil and gas assets in the development or production



phases in cost centers that include all properties in a large geographical area should, instead of following the above rules (1–3) or IFRIC 1:

1. Measure decommissioning, restoration and similar liabilities as of the date of transition to IFRS under IAS 37; and
2. Recognize directly in retained earnings any difference between that amount and the carrying amount of those liabilities at the date of transition determined under previous GAAP.

### ***Service concession arrangements***

A first-time adopter may apply the transitional provisions of IFRIC 12.

### ***Borrowing costs***

IFRS 1 permits a first-time adopter to apply the transitional provisions included in IAS 23 (as revised in 2007). The effective date in IAS 23 should be interpreted as the later of July 1, 2009, or the date of transition to IFRS. With the amendment to IFRS 1, per the Annual Improvements 2009–2011 Cycle published in May 2012, the first-time adopter may designate any date before the effective date and capitalize borrowing costs relating to all qualifying assets in accordance with IAS 23 for which the commencement date for capitalization is on or after that date. Additionally, once the first-time adopter applies this provision, they may not restate any previously capitalized borrowing costs as capitalized under the previous GAAP. This amendment is effective for annual periods beginning on January 1, 2013, and early adoption is allowed.

Based on the experience of EU and Australian companies, exceptions most likely to be elected by first-time adopters pertain to the following: business combinations, deemed cost, employee benefits, share-based payment and cumulative translation differences.

These exemptions from the full retrospective application of IFRS should benefit first-time adopters, by reducing the cost of implementing IFRS. Entities should evaluate potential impacts of electing to use the proposed exemptions, including implications for information systems, taxes and reported results of operations.

### ***Severe hyperinflation***

IFRS 1 permits a first-time adopter, if it has a functional currency that was, or is, the currency of a hyperinflationary economy, to determine whether it was subject to severe hyperinflation before the date of transition to IFRS.

The currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics:

1. A reliable general price index is not available to all entities with transactions and balances in the currency.
2. Exchangeability between the currency and a relatively stable foreign currency does not exist.

The functional currency of an entity ceases to be subject to severe hyperinflation on the functional currency's normalization date. That is the date when the functional currency no longer has either, or both, of the characteristics in the above paragraph, or when there is a change in the entity's functional currency to a currency that is not subject to severe hyperinflation. When an entity's date of transition to IFRS is on, or after, the functional

currency normalization date, the entity may elect to measure all assets and liabilities held before the functional currency normalization date at fair value on the date of transition to IFRS. The entity may use that fair value as the deemed cost of those assets and liabilities in the opening IFRS statement of financial position.

When the functional currency normalization date falls within a 12-month comparative period, the comparative period may be less than 12 months, provided that a complete set of financial statements as required by IAS 1 is provided for that shorter period.

## **PRESENTATION AND DISCLOSURE**

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IFRS 1 does not provide exemptions from the presentation and disclosure requirements in other IFRS.

### ***Explanation of transition to IFRS***

A first-time adopter that applied IFRS in a previous period and whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with IFRSs, and in the current period makes an *explicit and unreserved statement* of compliance with IFRS, has the choice of either (1) applying IFRS 1 (in full), or (2) retrospectively applying IFRS in accordance with the provision of IAS 8, *Accounting Policies, Changes in Estimates and Errors*. Should option 1 be applied, the first-time adopter must disclose its reason for not fully complying with IFRS in prior periods and the reason why it now does fully comply with IFRS. Should option 2 be applied, the first-time adopter must disclose its reasons for electing to apply IAS 8 full retrospective treatment in order to fully comply with IFRS (as if it had never stopped applying IFRS in the first place).

### ***Comparative information***

A first-time adopter must prepare and present an opening statement of financial position as of its transition date, in accordance with IFRS in effect as of the company's first reporting date. At least one year of comparative financial statement information has to be presented. To comply with IAS 1, *Presentation of Financial Statements*, an entity's first IFRS financial statements should include at least three statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information.

If an entity also presents historical summaries of selected data for periods prior to the first period that it presents full comparative information under IFRS, and IFRS does not require the summary data to be in compliance with IFRS, such data should be labeled prominently as not being in compliance with IFRS and also disclose the nature of the adjustment that would make that data IFRS-compliant.

### ***Reconciliations***

A first-time adopter must explain how the transition to IFRS affected its reported financial position, financial performance and cash flows. In order to comply with the above requirement, reconciliation of equity and profit and loss as reported under previous GAAP to IFRS should be included in the entity's first IFRS financial statements. Specifically, an entity should include a reconciliation of its equity reported under previous GAAP to its equity under IFRS, for both of the following dates: (1) the date of transition to IFRS, and (2) the end of the latest period presented in the entity's most recent annual financial statements

under previous GAAP. Consequently, IFRS 1 requires the following reconciliations to be presented in first IFRS financial statements:

- Reconciliations of the entity's equity reported under previous GAAP to its equity restated under IFRS for both of the following dates:
  - The date of transition to IFRS; and
  - The end of the latest period presented in the entity's most recent annual financial statements under previous GAAP.
- A reconciliation of the entity's total comprehensive income reported in most recent financial statements under previous GAAP to its comprehensive income under IFRS for the same period. The starting point for that reconciliation should be the amount of comprehensive income reported under previous GAAP for the same period. If an entity did not report such a total, the reconciliation starts with profit or loss under previous GAAP.
- In addition to the reconciliations of its equity and comprehensive income, if the entity recognized or reversed any impairment losses for the first time in preparing its opening IFRS statement of financial position, the disclosures that would have been required in accordance with IAS 36, if the entity had recognized or reversed those impairment losses in the period beginning with the date of transition to IFRS.

Consequently, for an entity adopting IFRS for the first time in its December 31, 20XX financial statements, the reconciliation of equity would be required as of January 1, 20XX-1, and December 31, 20XX-1; and the reconciliation of comprehensive income for the year 20XX-1. These reconciliations must provide sufficient detail enabling users to understand material adjustments to the statement of financial position and comprehensive income. Material adjustments to the statement of cash flows should also be disclosed. For all reconciliations, entities must distinguish the changes in accounting policies from corrections of errors.

### ***Other disclosures***

IFRS 1 requires first-time adopters to present other disclosures, including:

- Entities that designated a previously recognized financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss, or a financial asset as available-for-sale, should disclose the fair value designated into each category when this designation was made and the carrying amount in the previous financial statements.
- Entities that recognized or reversed any impairment losses for the first time in preparing opening IFRS statement of financial position need to present the disclosures required by IAS 36 as if those impairment losses or reversals had been recognized in the first period beginning with the date of transition to IFRS.
- Entities that used fair values in their opening IFRS statement of financial position as deemed cost for an item of property, plant and equipment, an investment property or an intangible asset, should disclose for each line item in the opening IFRS statement of financial position the aggregate of those fair values and the aggregate adjustments made to the carrying amounts reported under previous GAAP.
- Also, entities that apply the exemption to measure oil and gas assets in the development or production phases at the amount determined for the cost center under previous

GAAP (and this amount is allocated pro rata to the underlying assets, using reserve volumes or reserve values as of that date) should disclose that fact and the basis on which carrying amounts determined under previous GAAP were allocated.

### ***Interim reporting***

An entity adopting IFRS in an interim report (e.g., in quarterly or half-yearly financial statements) that is presented in accordance with IAS 34 is required to comply with IFRS 1, adopt IFRS effective at the end of the interim period, and prepare comparative financial information for interim periods.

#### **Example to illustrate the effect on interim reporting**

Xodus Inc. decides to present its first IFRS interim financial statements for the three months ended March 31, 20XX, in accordance with IAS 34, within its first IFRS reporting period ending on December 31, 20XX. Consequently, the first reporting date is March 31, 20XX and the company will be required to provide comparative IFRS financial information for the quarterly periods. If the company decided to present comparative information for one year only, then the March 31, 20XX-1, comparatives would have to be presented.

In accordance with IFRS 1, entities must be able to generate profit or loss statements also for interim periods and prepare certain reconciliations between amounts reported under previous GAAP and IFRS. In addition to satisfying the requirements of IAS 34, if an entity presented an interim financial report for the comparable interim period of the preceding financial year, the following reconciliations must be included:

- A reconciliation of the entity's equity reported under previous GAAP at the end of that comparable interim period, to its equity restated under IFRS at that date; and
- A reconciliation of the entity's comprehensive income reported under previous GAAP for that comparable interim period (if an entity did not report such a total, reconciliation of profit or loss under previous GAAP) to its restated comprehensive income under IFRS for the same period.

In addition to the reconciliations listed above, an entity's first interim financial report prepared under IAS 34 for part of the period covered by its first IFRS financial statements should also include reconciliations and other disclosures for the fiscal year. Also, IAS 34 requires an entity to disclose "any events or transactions that are material to an understanding of the current interim report."

It is anticipated, and recommended, that transition-period disclosures be presented as a complete package, covering:

- A full set of restated financial statements (statements of financial position, comprehensive income, cash flows and changes in equity);
- Notes explaining the restatement, including reconciliations from amounts reported under previous GAAP to restated amounts under IFRS; and
- Notes on the accounting policies to be applied under IFRS and exemptions applied at transition.

Additional footnote detail in the annual financial statements for the first year IFRS is applied, may also be useful. At a minimum, however, to provide a thorough understanding of the transition, it will be advisable to identify all the relevant factors considered by the

preparer (the reporting entity) in converting to IFRS, in the transition disclosure package itself.

### **Options *With* and *Within* the Accounting Standards**

An entity adopting IFRS for the first time may have a choice among accounting standards as well as accounting policies as a result of (1) options with accounting standards (newly issued IFRS), and (2) options within accounting standards.

In conformity with IFRS 1, an entity should adopt IFRS issued and effective at the reporting date of the entity's first IFRS financial statements. Some IFRS may not be issued as of the date of an entity's transition to IFRS but will be effective at the reporting date. It is also possible to adopt a standard whose application is not yet mandatory for the reporting period but whose early adoption is permitted. The IASB has a number of projects currently on its agenda where standards are expected to be finalized in the near future with application dates beyond that date, including those dealing with such matters as derecognition, liabilities, share-based payments and accounting for income taxes. An entity is required to apply the same version of the IFRS throughout the periods covered by those first IFRS financial statements.

On first-time adoption of IFRS, an entity must choose which accounting policies will be adopted. IFRS require an entity to measure some assets and liabilities at fair value, and some others (for example, pension liabilities) at net realizable value or other forms of current value that reflect explicit current projections of future cash flows. An entity will have a choice between different options of accounting policies within accounting standards that may be applied in preparing its first IFRS financial statements. Examples of areas where options within IFRS exist include: cost versus revaluation model of accounting for property, plant, and equipment and intangible assets (IAS 16, IAS 38); cost versus fair value model of accounting for investment property (IAS 40); cost versus fair value of jointly controlled entities (IFRS 11, IAS 27); and fair value versus proportionate share of the acquiree's identifiable net assets to measure non-controlling interest in consolidated financial statements (IFRS 3). There are several other areas where there is a choice of accounting policies under IFRS which may have a significant impact on an entity's future results. Once an accounting policy is adopted, opportunities to change may be restricted to justified situations where the change would result in a more appropriate presentation.

In many respects, entities are given a "fresh start" and are required to redetermine their accounting policies under IFRS, fully restating past comparative information. The limited optional exceptions also present some opportunities for entities to determine optimal outcomes.

### **Transition from US GAAP to IFRS: The Case of DaimlerChrysler**

DaimlerChrysler (former Daimler Benz, today Daimler AG) adopted US GAAP in 1998 for purposes of listing on the NYSE. Since it reported under US GAAP in 2005, DaimlerChrysler was exempted until 2007 from implementing the EU Regulation on adopting IFRS. In May 2007, DaimlerChrysler announced that it would sell 80.1% of its stake in the Chrysler Group. Although the company no longer operates the Chrysler Group, it continues to trade on the NYSE and to carry US-issued debt. In November 2007, the SEC eliminated the requirement for foreign registrants reporting under IFRS to reconcile their financial statements to US GAAP. In 2007, DaimlerChrysler had to implement IFRS and its

2007 financial statements were prepared in accordance with IFRS, as issued by the IASB and endorsed by the EU.

DaimlerChrysler followed the provisions of IFRS 1, *First-Time Adoption of IFRS*, to prepare its opening IFRS statement of financial position at the transition date. In accordance with IFRS 1, DaimlerChrysler's *date of transition* to IFRS, on which the opening IFRS statement of financial position was prepared, was January 1, 2005, since the company presented two years of comparative financial statements (2005 and 2006). As required by IFRS 1, each IFRS effective at the reporting date of DaimlerChrysler's first IFRS-compliant financial statements (December 31, 2007) was retrospectively applied.

Certain of DaimlerChrysler's IFRS accounting policies applied in the opening statement of financial position differed from its US GAAP policies applied on that date. The resulting adjustments which arose from events and transactions before the date of transition to IFRS were recognized directly in retained earnings (or another category of equity where appropriate, as of January 1, 2005). The impacts of IFRS adoption on the financial statements are presented in Examples 1–2 below along with the footnote, Example 3, taken from the reissued 2006 report which provides explanation of the differences between IFRS and US GAAP that had major impacts on the financial reports.

**Example 1: Statement of financial position impacts of DaimlerChrysler's transition to IFRS**

Reconciliations of DaimlerChrysler's equity reported under US GAAP to its equity under IFRS at the transition date (January 1, 2005) and at the end of two comparative periods, 2005 and 2006, presented under US GAAP.

<i>(in millions of €)</i>	<u>At December 31, 2006</u>	<u>At December 31, 2005</u>	<u>At January 1, 2005</u>
Stockholders' equity under US GAAP (as reported)	34,155	36,449	33,522
Adjustments	154	131	169
Stockholders' equity under US GAAP (adjusted)	34,309	36,580	33,691
Minority interest (a)	663	653	909
Stockholders' equity under US GAAP (adjusted) and minority interest	34,972	37,233	34,600
Development costs (b)	5,066	5,142	4,710
Borrowing costs (c)	(843)	(977)	(910)
Investment in EADS (d)	810	1,142	972
Inventories (LIFO) (e)	477	495	349
Transfer of financial assets/ leveraged leases (f)	(517)	(556)	(552)
Pension and other post-employment benefits (g)	(752)	(7,670)	(7,728)
Provisions (h)	321	764	678
Other adjustments (i)	(677)	(872)	(740)
Income taxes (j)	(1,408)	1,359	1,392
Total reconciling items	2,477	(1,173)	(1,829)
Equity under IFRS	37,449	36,060	32,771

**Example 2: Income statement impacts of DaimlerChrysler's transition to IFRS**

Reconciliation of DaimlerChrysler's net income reported under US GAAP to its net profit under IFRS for two comparative periods, 2005 and 2006, presented under US GAAP.

<i>(in millions of €)</i>	<u>2006</u>	<u>2005</u>
Net income under US GAAP (as reported)	3,227	2,846
Adjustments	19	(43)
Net income under US GAAP (adjusted)	3,246	2,803
Minority interest (a)	56	74
Net income under US GAAP (adjusted) including minority interest	3,302	2,877
Development costs (b)	145	274
Borrowing costs (c)	47	52
Investment in EADS (d)	(468)	165
Inventories (LIFO) (e)	12	55
Transfer of financial assets/leveraged leases (f)	(61)	(4)
Pension and other post-employment benefits (g)	1,558	1,081
Provisions (h)	(374)	24
Other adjustments (i)	212	60
Income taxes (j)	(590)	(369)
Total reconciling items	481	1,338
Net profit under IFRS	3,783	4,215

**Example 3: Required explanation**

An explanation of how the transition from US GAAP to IFRS has affected DaimlerChrysler's earnings, financial position and cash flows is presented in the following tables and notes that accompany the tables.

- a. **Minority interest.** Under IFRS, minority interests are included in equity, and net profit includes the portion allocated to the minority interest holders. Under US GAAP net income only includes the income attributable to the shareholders of DaimlerChrysler AG. The amounts of the reconciling items (b) – (j) presented in the tables above also include the amounts allocable to minority interest holders.
- b. **Development costs.** Under US GAAP, with the exception of certain software development costs, all development costs are expensed as incurred in accordance with ASC 730, *Accounting for Research and Development Costs*. Under IFRS, development costs are capitalized as intangible assets if the technical and economic feasibility of a project can be demonstrated. These costs are subsequently amortized on a straight-line basis over the expected useful lives of the products for which they were incurred (i.e., they become a part of the production costs in which the component for which such costs were incurred is used). Once these vehicles are sold, the amortization of development costs is included in cost of sales.
- c. **Investment in EADS.** Differences between US GAAP and IFRS also affect the carrying amount and DaimlerChrysler's equity in the earnings of EADS, a significant equity investee. DaimlerChrysler accounts for its investment in EADS at a three-month time-lag. Under US GAAP, transactions and events that occur during the intervening period between September 30, 2006, and DaimlerChrysler's reporting date do not result in adjustments, but are disclosed if significant. Under IFRS, the financial information of EADS has to be adjusted for significant transactions and events that occurred after September 30, 2006, but before DaimlerChrysler's reporting date. EADS recorded significant charges in the fourth quarter of 2006, primarily in connection with problems with the A380 program and resulting

delivery delays and the decision to launch the industrial program for the new A350XWB aircraft family.

In 2003, under US GAAP, DaimlerChrysler determined that the decline in fair value below the carrying value of its investment in EADS was other than temporary and reduced the carrying value by €1.96 billion to its market value. The fair value was determined using the quoted market price, which approximated €3.5 billion at that time. Under IFRS, the investment would not have been considered impaired because the fair value would have been determined using the higher of fair value or value in use, which at that time exceeded the carrying amount.

- d. **Inventories (LIFO).** Under US GAAP, the Group accounted for certain inventories of US subsidiaries using the last-in, first-out principle (LIFO). Under IFRS, the use of LIFO is prohibited, as set forth in IAS 2, *Inventories*.
- e. **Transfer of financial assets/leveraged leases.** As part of its financing activities, the Group regularly sells certain financial receivables from its financial services business as well as trade receivables to special-purpose entities (SPEs) and other third parties (“transfer of financial assets”).

In the US GAAP financial statements, transferred receivables meeting the derecognition conditions are removed from the balance sheet, any consideration received including retained interests is recognized, and gains or losses from the sale of such receivables are recognized in income. In contrast, in the IFRS consolidated balance sheets as of December 31, 2006 and 2005, receivables of €21.7 billion and €21.3 billion respectively, (primarily receivables from financial services), and liabilities of €21.7 billion and €21.3 billion respectively, (primarily financing liabilities), were reported which are not recorded on the balance sheets in accordance with US GAAP.

Under US GAAP, investments in leveraged leases are recorded on a net basis, (i.e. non-recourse financing has been offset against the rental receivable of the lessor). The investment in leveraged leases is included in the line item receivables from financial services in the consolidated balance sheets. Revenue from leveraged leases is recognized under the effective interest method using an after-tax rate of return on the net investment. Under IFRS, investments in leveraged leases are generally recorded on a gross basis on the consolidated balance sheet as receivables from financial services, including the unguaranteed residual value, while the related non-recourse debt is presented as a financial liability. Interest on the receivable is recognized as revenue based on a constant rate of return before taxes, at the rate implicit in the lease. As a result, in the IFRS consolidated balance sheets as of December 31, 2006 and 2005, the Group reported additional receivables from financial services of €1.5 billion and €2.0 billion and liabilities of €1.8 billion and €2.3 billion, respectively, compared to the US GAAP carrying amounts. In addition, certain investments in leveraged cross-border leases are not accounted for as leases at all under IFRS, but represent financial instruments for which revenue is recognized based on their rate of return before income taxes.

- f. **Provisions.** In accordance with IFRS, long-term provisions must be discounted to their present value if the effect from discounting is material. Under US GAAP, discounting is only permissible for specific types of provisions if the amount and timing of the cash flows can be reasonably predicted.

This item also includes differences between US GAAP and IFRS relative to the accounting for early retirement agreements concluded in the framework of the German *Altersteilzeit* benefits. Under US GAAP, all payments during the inactive phase are accrued with a corresponding charge to earnings over the period from reaching an early retirement agreement to the end of the employment. Under IFRS, however, the incremental benefit payments are fully recognized as expenses at the time the early retirement agreement is signed. In 2006, DaimlerChrysler changed its estimates of the effects of employee bonuses and other benefits upon adoption of EITF 05-5, *Accounting for Early Retirement or Post-employment Programs*



with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements), and recognized a gain of €166 million, or €102 million, net of taxes.

- g. **Other adjustments.** Other adjustments consist of a number of individually small different recognition and measurement provisions, including the effects of the elections to adjust retained earnings at the transition date for accumulated foreign currency translation differences upon transition to IFRS on gains or losses from disposals of foreign operations, the recognition of gains from sales of real estate leased back under the terms of operating leases, puttable minority interest and other items.
- h. **Income taxes.** The adjustments for income taxes are mainly due to the tax effects of differences between IFRS and US GAAP.

This reconciliation item also includes adjustments owing to the use of different tax rates in the elimination of intercompany profits, different valuation allowances on deferred taxes and differences in recognition of uncertain income tax benefits.

The differing valuation allowances, mainly for state and local taxes in the United States of America, are a result of the varying temporary differences under US GAAP compared to IFRS.

Until December 31, 2006, DaimlerChrysler recognized in its US GAAP financial statements the benefit of an uncertain income tax position only when it was probable that the tax position would be sustained based solely on the technical merits of the position and the application of the law. Under IFRS, the potential tax exposure from an uncertain income tax position has to be determined by using the best estimate of the probable amount which results in the recognition of the benefit from a tax position when it is more likely than not that it will be realized.

**Information on the statement of cash flows.** The presentation of cash flows between IFRS and US GAAP differs primarily because of investments in development projects which are capitalized and reported as investing activities under IFRS, accounting for transfers of receivables which fail derecognition under IFRS and are presented as a secured borrowing under IFRS and inventory-related operating leases between DaimlerChrysler and a customer which are presented as operating activities under IFRS.

<i>(in millions of €)</i>	<u>2006</u>	<u>2005</u>
Cash provided by operating activities under US GAAP	14,016	12,353
Difference	321	(1,321)
Cash provided by operating activities under IFRS	14,337	11,032
Cash used for investing activities under US GAAP	(14,581)	(11,222)
Differences	(1,276)	985
Cash used for investing activities under IFRS	(15,857)	(10,237)
Cash provided by (used for) financing activities under US GAAP	496	(1,513)
Differences	1,900	229
Cash provided by (used for) financing activities under IFRS	2,396	(1,284)

#### Example 4: First-time adoption by Meikles Group

### 2. Basis of Preparation

The Group's financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS). The financial statements are prepared from statutory records that are maintained under the historical cost convention as modified by the revaluation of property, plant, and equipment, biological assets, and financial instruments which are measured at fair value in the opening statement of financial position.

## 2.1 Transition to IFRS

The Group is resuming presentation of IFRS financial statements after the Group issued financial statements in the prior reporting period ended December 31, 2009, which could not include an explicit and unreserved statement of compliance with IFRS due to the effects of severe hyperinflation. As discussed in note 2.5, the group has early adopted the amendments to IFRS 1 and is therefore applying that standard in returning to compliance with IFRS. The Group's functional currency for the period before January 1, 2009, the Zimbabwe dollar (ZW\$) was subject to severe hyperinflation because it had both the following characteristics:

- A reliable general price index was not available to all entities with transactions and balances in ZW\$ because the Zimbabwe Central Statistical office did not release the consumer price indices from August 1, 2008, while the existence of market distortions made measurement of inflation by alternative means unreliable; and
- Exchangeability between the ZW\$ and a relatively stable foreign currency did not exist.

The Group's functional currency ceased to be subject to severe hyperinflation from January 1, 2009, when the Group changed its functional currency from ZW\$ to US\$.

## 2.2 Exemption for fair value as deemed cost

The Group elected to measure certain items of property, plant, and equipment, biological assets, bank balances and cash, inventories, other financial assets, other financial liabilities, and trade and other payables at fair value and to use the fair values as the deemed cost of those assets and liabilities in the opening statement of financial position as of January 1, 2009.

## 2.3 Comparative financial information

The financial statements comprise three statements of financial position, and two statements of comprehensive income, two statements of changes in equity and two statements of cash flows, as a result of the retrospective application of the amendments to IFRS 1. The comparative statements of comprehensive income, changes in equity and cash flows are for 12 months.

## 2.4 Reconciliation to previous basis of preparation

The Group's financial statements for the prior period ended December 31, 2009, claimed compliance with IFRS, except certain of the requirements of IAS 1, *Presentation of Financial Statements*, IAS 21, *The Effects of Changes in Foreign Exchange Rates*, and IAS 29, *Financial Reporting in Hyperinflationary Economies*. Certain prior year errors were identified during the period and a reconciliation of the amounts previously stated in the December 31, 2009 financial statements and the comparative amounts as presented in this report is given in Note 32.

## 32. Prior Year Adjustments

### 32.1 Opening balances of property plant and equipment

During the period errors were identified on the January 1, 2009 carrying amounts of certain property, plant, and equipment for the stores and agricultural operations. The assets were omitted from the valuation exercise carried out at January 1, 2009, when the functional currency was changed from ZW\$ to US\$. This has been corrected by the restatement of the 2009 comparatives included in these financial statements.

### 32.2 Opening balances of biological assets other receivables and nursery stocks

During the period, it was discovered that the carrying amounts of certain biological assets of the agricultural segment were understated while certain receivables and nursery stocks were

incorrectly valued at January 1, 2009, resulting in a misstatement of the opening carrying amounts. The error has been corrected in the comparative statements of financial position.

Presented below are only those statements of comprehensive income and statements of financial position items which have been impacted by the prior year adjustments.

### 32.3 Prior year costs reclassification

**Certain prior year costs have been reclassified to conform to current year presentation.**

#### Statement of comprehensive income

	<i>December 31, 2009 previously stated</i>	<i>Adjustments of property, plant, and equipment</i>	<i>Adjustments to biological assets</i>	<i>December 31, 2009 restated</i>
	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>
Other operating costs	(16,067,056)	(862,866)	--	(16,929,922)
Fair value adjustments	(35,712)	--	2,116,946	2,081,234
Income tax	5,449,453	384,330	(545,114)	5,288,669
Loss for the year from continuing operations	(3,747,889)	(478,536)	1,571,832	(2,654,593)
Total comprehensive loss for the year	(3,824,645)	(478,536)	1,571,832	(2,731,349)

#### Statements of financial position

	<i>January 1, 2009 as previously stated</i>	<i>Adjustments of property, plant and equipment</i>	<i>Adjustments to inventories</i>	<i>Adjustments to trade and other receivables</i>	<i>January 1, 2009 restated</i>
<i>January 1, 2009</i>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>
Property, plant and equipment	89,650,542	4,720,754	--	--	94,371,296
Inventories	5,565,764	--	(502,194)	--	5,063,570
Trade and other receivables	10,280,439	--	--	(152,007)	10,128,432
Total assets	200,489,141	4,720,754	(502,194)	(152,007)	204,555,694
Non-distributable reserves	(148,118,994)	(3,476,943)	502,194	152,007	(150,941,736)
Deferred tax liability	(23,074,660)	(1,243,811)	--	--	(24,318,471)
Total equity and liabilities	(200,489,141)	(4,720,754)	502,194	152,007	(204,555,694)

	<i>December 31, 2009 as previously stated</i>	<i>January 1, 2009 net adjustments as above</i>	<i>Adjustments of property, plant, and equipment</i>	<i>Adjustments to biological assets</i>	<i>December 31, 2009 restated</i>
<i>December 31, 2009</i>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>	<u>US \$</u>
Property, plant, and equipment	76,672,807	4,720,754	(862,866)	--	80,530,695
Biological assets	4,193,614	--	--	2,116,946	6,310,560
Inventory	17,617,464	(502,194)	--	--	17,115,270
Trade and other receivables	7,485,896	(152,007)	--	--	7,333,889
Total assets	271,429,262	4,066,553	(862,866)	2,116,946	276,749,895
Non-distributable reserves	(107,160,978)	(2,822,742)	--	--	(109,983,720)
Accumulated loss	22,418,679	--	478,536	(1,571,832)	21,325,383
Deferred tax	(13,941,913)	(1,243,811)	384,330	(545,114)	(15,346,508)
Total equity and liabilities	(271,429,262)	(4,066,553)	862,866	(2,116,946)	(276,749,895)